

# Does It Pay for Entertaining Your Stakeholders?\*

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## Abstract

Using a unique dataset on business entertainment expenditure (BEE) spent by Chinese public firms from 2004 to 2012, this paper performs the first systematic study on the effects of BEE on firm performance. We find that BEE can improve future firm performance and firm valuation, while it has not been fully anticipated by investors and analysts. We document that BEE can improve the quality of trade credit extended to customers, acquire more trade credit from suppliers, secure more government subsidies, lower collateral requirement of bank borrowings, and reduce litigation incidences. We further find that BEE generates more benefits for firms that face higher transaction costs in dealing with business partners and are politically favored by governments. Finally, we find the beneficial effects of BEE tend to be stronger for firms with better governance. Overall, our results suggest that BEE is value-enhancing, though it may also suffer from agency problems.

**Keywords:** Business Entertainment Expenditure; Transaction Costs; Favor-seeking; Firm Performance; Stakeholders

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## 1. Introduction

Entertaining business stakeholders is one of longstanding and prevalent corporate activities. Business entertainment expenditure (BEE) is generally considered as necessary operating costs and is granted tax deductible status. For instance, BEE has been deductible since the inception of the nation's revenue laws in the U.S in 1906 (Schmalbeck and Soled, 2009).<sup>1</sup> Business entertainment is also prominent in practices, especially in Asian countries, where people are more likely to rely on personal relationships to smooth and/or secure their transactions. According to market researcher Chaebul.com, 3.6 million companies in Korea spent about \$ 6.24 billion on BEE in 2012, equivalent to 0.19% of the combined sales.<sup>1</sup> In China, the data we compiled indicates that BEE accounts for 0.23% of the combined sales and 4.5% of the combined net income from 2004 to 2012. These numbers imply the prevalence and significant magnitude of BEE.<sup>2</sup>

Although the use of BEE by firms is considerable and widespread, we know very little about why firms want to entertain their stakeholders, whether and how firms benefit from these activities. To our best knowledge, there is no study systematically investigating such issues, probably due to the lack of relevant data. Taking advantage of the disclosure of BEE by the publicly listed firms in China from 2004 to 2012, this paper attempts to explore these

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<sup>1</sup> More and more countries in both mature and developing markets have made increased efforts to fight against perceived lavish business entertainment. The deductible rate for BEE has been reduced to a certain rate, but it is still largely deductible. For example, the tax deductible rate for BEE is reduced to 50% now in the U.S and Canada, while remains at 70% in Germany. For BRIC countries, the deductible rate is 50% in Brazil, 100% if BEE is less than 4% of the total annual pay-roll expenses in Russia, 60% if BEE is less than 0.5% of sales in China. In India, BEE is also partially tax deductible based on the information on the internet, but we are not able to find the exact deductible rate. These figures suggest that governments continue to recognize BEE as part of firms' necessary operating costs.

<sup>2</sup> To our best efforts, we are still unable to find the BEE data for other countries, except for some anecdotes. For instance, some anecdotes suggest that BEE is also very prominent in Japan. In a report by Reuters in 1985, titled "Expenses for Business Entertainment Exceed the Defense Budget in Japan", it estimated that "For a small company, business entertaining probably amounts to 20% of its costs." A recent report by Financial Times in 2013 confirmed that Japan has had a history of somewhat excessive business entertainment.

[http://articles.latimes.com/1985-01-20/business/fi-10764\\_1\\_business-entertainment](http://articles.latimes.com/1985-01-20/business/fi-10764_1_business-entertainment),  
<http://www.ft.com/intl/cms/s/0/b752ca22-1c5d-11e3-8894-00144feab7de.html>

questions.

When firms entertain their stakeholders through business lunches, concert shows, sporting events, or any other activities, they can spend some time together in a relaxed atmosphere, in which most people tend to let their guard down a little and share more personal experiences. This is a good way to know other people like their personalities and needs, and also good for developing networks and bonding relationships with a firm's major stakeholders. The well-established stakeholder theory (e.g., Freeman, 1984; Donaldson and Preston, 1995) in management studies has proposed several decades ago that building and maintaining good relationships with stakeholders are essential for firm success. This theory has also been gradually embraced by scholars in other disciplines including finance (e.g., Zingales, 2000; Jensen, 2001). We expect that building and maintaining good relationship with stakeholders through entertainment activities can lead to better firm performance for two reasons. Firstly, entertainment activities can mitigate transaction costs that a firm has to overcome in conducting market-based transactions with their business partners (e.g., Dahlman, 1979; Dyer and Chu, 2003; North, 1990). According to Coase (1960), transaction costs refer to the costs involved in market exchange, including the costs of discovering market prices and the costs of writing and enforcing contracts. Based on the sequence of the transactions process itself, Dahlman (1979) further classifies transaction costs into three broad categories: search and information costs, bargaining and decision costs, policing and enforcement costs. As argued by scholars in transaction economics, the root to transaction cost is the lack of information, which can create obstacles for the realization of profitable business opportunities (Dahlman, 1979; North, 1990). Entertaining business partners can facilitate communication and

information sharing between firms and their business partners, which consequently help to lower the transaction costs faced by firms and realize the profitable business opportunities that might be otherwise thwarted by the high transaction costs.

Second, entertaining stakeholders can help firms to achieve favorable outcomes in public sectors such as governments and state-owned entities. Public choice theorists in economics and political scientists have long argued that decisions or outcomes in public sectors are not completely determined by objective rules or procedures but can be shaped by the lobbying or other organizing activities of interested groups or powerful economic actors (Bernstein, 1955). The effectiveness of these activities depends crucially on the degree of influences that the interest groups/individual actors can exercise over the decision-making of the bureaucrats, which in turn be affected by the information sharing between lobbying groups and bureaucrats (Abney and Lauth, 1986; Brudney and Hebert, 1987), the ability of lobbying groups to gain access to bureaucrats (Culhane, 1981), and the perceived power or favorability of the lobbying groups vis-à-vis their competitors in the eyes of bureaucrats (Khwaja and Mian, 2005). We expect that entertaining stakeholders in public sectors can allow firms to exercise greater influence over the decision-making of public organizations by facilitating information sharing; gaining access to the relevant administration or even directly title the relatively favorability of a firm relative to its competitor.

Our empirical analyses reveal three main findings. First, we find that BEE can improve firm performance. Specifically, after controlling for a batch of independent variables, year, industry and firm fixed effect, we find that one RMB increase in BEE can improve sales and net profit in the next year by 14.7 and 2.0 RMB, respectively. Firms with one RMB more in

BEE are associated with 19.4 RMB higher in their market valuation concurrently. These results suggest that firms do benefit from BEE.

Second, we provide evidence that the information about future firm performance contained in BEE has not been fully recognized by investors and analysts. We find that higher BEE firms earn higher risk-adjusted returns in the subsequent 12 months. A hedged portfolio that longs the top quintile BEE firms and shorts the bottom quintile BEE firms earns significantly 0.44% (for equal-weighted, 0.73% for value-weighted) per month over the next 12 months. In addition, we find high BEE firms tend to have high future unexpected earnings.

To understand why BEE can improve firm performance, we take a closer look by exploring the benefits of BEE from four main outside stakeholders: customers, suppliers, governments, and creditors. We find that BEE can improve the quality of trade credit extended to customers and acquire more trade credit from suppliers, with these effects being stronger for firms facing higher transaction costs in dealing with their customers and suppliers, respectively. We also find that BEE can help firms secure government subsidies, with the effects being stronger for state-owned firms, larger firms and when government officials are in their early tenure. Finally, we find that BEE can lower collateral requirement of bank borrowings. The effects are stronger for SOEs, firms with political connectedness and more financial constrained firms. Overall, the results suggest that BEE can help firms to obtain favorable treatments from various stakeholders with the benefits being greater for the firms that face high transaction costs in dealing with business partners or are politically favored by governments

We also examine whether BEE is associated with fewer incidence of lawsuits experienced

by firms, because the occurrence of lawsuits is a de facto indicator of the difficulties in reaching and enforcing contracts. We find that BEE can reduce litigation incidences and this effect is weaker for firms with more related party transactions. Firms with more related party transactions tend to rely less on external market transactions and thus face lower transaction costs. These results also lend some support to our conjecture that BEE can mitigate transaction costs in market transactions.

Finally, we investigate the role of corporate governance by splitting our sample into firms with a strong versus weak governance structure. We find that the effects of BEE are stronger for firms with a strong governance structure on most dimensions that we have examined. Although we do not find the evidence that BEE destroys firm value, the weak positive effect of BEE in firms with a weak governance structure seemingly suggests that some BEE in these firms might have been inflated or represent personal consumptions.

Naturally, there are concerns that our findings may be driven by endogeneity. In addition to using one year lagged explanatory variables, and controlling for year, industry and firm fixed effect, we adopt the instrumental variable approach to mitigate the concern. Following similar arguments in Nevo (2001) and Cai, Fang and Xu (2011), we use the median BEE of other firms within the same industry at two-digit level in a given year as the instrument. The underlying logic is that firms within the same industry share some common but unmeasurable factors that affect BEE, such as specific product attributes and industry regulations. Therefore, the industry median BEE is correlated with firm BEE but less likely affect other firm outcomes directly, except indirectly through BEE. We use the IV approach to repeat our analyses and find similar results.

Our study contributes to the literature in several ways. First, this is the first study that systemically explores the reasons and benefits of entertaining business stakeholders. The closest study to ours is Cai et al. (2011), who use World Bank survey dataset to study the effect of Entertainment and Travel Costs (ETC) on firm performance. Entertainment Costs and Travel Costs actually are two separated accounting items, which are reported in a single item in their survey data. Entertainment Costs in ETC are our BEE, while Travel Costs in ETC refer to expenses incurred when an employee conducts business away from home including any lodging, meals, or transportation costs.<sup>3</sup> Therefore, our measurement of BEE is different from ETC. Cai et al. (2011) use ETC to proxy the level of corruption and find a negative relation between ETC and firm performance. Our study, however, focuses on the entertainment expense itself and finds a positive relation between BEE and firm performance.

Second, we contribute to the young but growing literature on the importance of social networks in corporate finance (e.g., Hochberg, Ljungqvist, and Lu, 2007; Engelberg, Gao, and Parsons, 2012a, 2012b). Prior studies have found that a firm's social networks can facilitate the various corporate activities such as investment performance (Hochberg et al., 2007) and bank borrowing (e.g., Engelberg et al., 2012a). Our study focuses on the activities that build up the social networks. Although BEE only accounts for 2.7% of the SGA in our sample, our results show that firms can reap significant benefits from different stakeholders. Our study not only reveals the mechanisms on how social networks can be produced, but also

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<sup>3</sup> <http://financial-dictionary.thefreedictionary.com/Travel+and+Entertainment+Expense>. It is possible that some Travel Costs might include some BEE such as sharing a cab or a meal, while it is reasonable to believe that most parts of Travel Costs should not be related to entertainment costs as firms normally have certain policies on Travel Costs, such as the amount of compensation per day for meals, lodging and transportation. In Cai et al. (2011), the average and median of ETC divided by sales is 1.5% and 0.6%, respectively. However, the average and median BEE divided by sales are 0.46% and 0.27% during the similar period (2004 and 2005) in our sample. Their average and median are three times and twice more than the numbers in our sample, which are consistent that BEE is only a part of ETC. In the example in Table B1, Travel Costs are about 36.66 times of BEE, suggesting that Travel Costs may account for a substantial portion of ETC.

adds further evidence to demonstrate its significant benefits for firms.<sup>4</sup>

Third, it relates to the literature on transaction costs economics by uncovering how firms mitigate their transaction costs through a particular channel – entertaining their stakeholders. As transaction costs are hard to measure, there are rare empirical studies at firm level (Macher and Richman, 2008). We introduce a new dataset that is systematically available for public firms in China and that might be useful in studying related issues.

The rest of the paper is organized as follows. Section 2 describes the data and summary statistics. Section 3 examines the determinants of BEE. Section 4 relates BEE and firm performance. Section 5 explores future stock returns and unexpected earnings. Section 6 investigates the benefit of BEE from different stakeholders. Section 7 explores the role of corporate governance. Section 8 concludes. Appendix A includes the definitions of all variables used in this study and their data sources.

## **2. Dataset and Sample Characteristics**

### *2.1 Data Sources*

We hand-collect data of BEE from annual reports of all non-financial firms listed on A-share market in either Shanghai or Shenzhen stock exchanges from 2004 to 2012. We exclude financial firms because their financial statements are compiled under different accounting standards. The year 2004 is chosen as the initial year because some data used in our main analyses are available only since 2003 (e.g., data of reserves for account receivables) and we need one year lagged data for some of our analyses. Our detailed data collection

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<sup>4</sup> Although recent studies on organizational capital propose using SGA to capture firms' organizational capital ((Eisfeldt and Papanikolaou, 2013; Li, Qiu, and Shen, 2014) and BEE is a part of SGA, BEE is more related to a firm's social networks than its organization capital. Evenson and Westphal (1995, p. 2237) describe organizational capital as "the knowledge used to combine human skills and physical capital into systems for producing and delivering want-satisfying products".



procedures are explained in Appendix B.

Similar to disclosure policies in other countries, the publicly listed firms in China are not mandatory to disclose information on BEE. Fortunately, a large fraction of them actually disclose BEE in their annual reports as they are mandated by regulators to list major categories of their main accounting items in footnotes such as SGA. Among our initial sample of 15,396 firm-year observations for 2,487 non-financial listed firms during our investigation period, we find 9,263 firm-year observations for 2,132 firms that have disclosed BEE. After excluding the observations with missing value on our key variables, our final sample includes 13,363 firm-year observations for 2,445 firms and 8,100 firm-year observations have valid BEE.<sup>5</sup> In our empirical analyses, we use the Heckman two-stage model to correct self-selection bias.

Our main dataset for constructing other variables is China Stock Market & Accounting Research Database, which is widely used by many prior studies (e.g., Fan, Wong, and Zhang, 2007; Giannetti, Liao, and Yu, 2014). Other databases used in this study include Wind, GW and iFind. Wind is equivalent to the Bloomberg in China, while GW and iFind are well-known databases provided by two public firms in China.

## *2.2 Descriptive Characteristics*

Panel A in Table 1 presents the summary statistics of BEE by year in our final sample.

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<sup>5</sup> Our initial sample includes 2,487 firms, with a total of 15,396 firm-year observations. Our final sample is obtained after applying the following screening process. 943 firm-year observations (635 of them have valid BEE) are excluded due to missing information on the amount of reserves allocated for account receivables as this information is disclosed in the notes of accounts in financial statements and therefore not mandatory. 526 firm-year observations (245 of them have valid BEE) are dropped due to missing information on customer-base or supplier-base concentration. 333 firm-year observations (178 of them have valid BEE) are further discarded with negative equity as these firms are practically bankrupt and their behavior might be systemically different. 125 firm-year observations (62 of them have valid BEE) are eliminated due to missing information on board. Finally, we exclude 58 firm-year (43 of them have valid BEE) observations with missing information on other variables. If we exclude the variables of reserves, customer and supplier concentration, the final sample size can increase to 14,832 firm-year observations. Under this circumstance, the percentage of our firm-year observations with missing information on our explanatory variables is similar to that of Giannetti, Liao and Yu (2014). The empirical results throughout the paper still hold if we use this larger dataset.

The pattern of disclosure rates over the years is similar to the one in Table B2 in Appendix B. The disclosure rates are around 37% during the period of 2004 to 2006, increase to about 43% in 2007 and 2008, further jump to 77% in 2009, and then stay around 78% afterwards. This uptrend reflects a series of reforms of Chinese accounting principles since the early 1990s.<sup>6</sup> The magnitude of BEE is fairly large no matter how we scale it. The average (median) value of BEE scaled by total assets, sales and operating profits are 0.26% (0.19%), 0.53% (0.32%) and 10.37% (4.10%), respectively.

Panel B in Table 1 displays the summary statistics of BEE by industry at two-digit level, which is compiled by CSRC and consists of 21 industries. We sort the industry by the median ratio of BEE to total assets. Information Technology industry has the highest ratio of BEE to total assets, total sales and operating profits, followed by Pharmaceutical Products and Communication & Culture industry. On the other hand, the industries of Utilities, Real Estate and Furniture have the lowest ratios of BEE to total assets. Compared to the industries lie in the bottom of Panel B, the product and/or service qualities of those industries on the top of Panel B seem to be more difficult to be verified. As a result, buyers and sellers need more time to search for eligible trading partners, have more issues to be negotiated before signing the contracts, and require more investment to police the resultant contracts. Put differently, industries on the top of Panel B seemingly face high transaction costs.

Panel C in Table 1 displays the summary statistics for other firm characteristics used in our study. The last column indicates the number of valid observations in our analyses. The

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<sup>6</sup> The significant jump in year 2009 is largely due to a special notice disseminated by Minister of Finance of China, which required all levels of governments to monitor the implementation of new accounting standards by firms registered in their jurisdictions on December 24, 2009. This notice specifically called for particular attention to firms listed in the Growth Enterprise Market in the Shenzhen Stock Exchange (hereafter GEM firms). Consistent with this notice, Table B2 in Appendix B shows that the disclosure percentage for GEM firms is 9%-13% higher than that for firms listed in the Shanghai stock exchange, and about 6%-12% higher than that for SME firms listed in the Shenzhen stock exchange.

subpanel of *Corporate Outcomes* presents summary statistics of corporate outcomes on which the effects of BEE will be examined. The subpanel of *Other Firm Characteristics* displays summary statistics of our main explanatory variables. The natural logarithm of firms' market value has both a mean and a median of around 21.1. The leverage has a mean of 0.463 and the median slightly higher than the mean. SOEs account for 54% of all firm-year observations.

[Table 1 here: Summary statistics]

### **3. Which Firms Spend More on Business Entertaining Activities?**

#### *3.1 Measures of Explanatory Variables*

##### *A. Key Explanatory Variables*

Based on these characteristics of transaction cost, we construct several variables to proxy transaction costs faced by firms in dealing with their business partners. Inspired by previous studies (e.g., Kalwani and Narayanda, 1995; Kumar, 1996; Patatoukas, 2012), we use customer-base concentration, defined as the proportion of sales to top five customers, to capture the transaction costs faced by firms in doing business with customers. By definition, more concentrated customer-base means that firms and their customers tend to conduct transactions more frequently and have a greater degree of mutual dependence. Therefore, uncertainty and opportunistic behavior in transactions will be alleviated, which will lower transaction costs for firms in dealing with customers. The similar logic applies to supplier-base concentration, which is defined as the proportion of procurement from top five suppliers, to proxy for the transaction costs encountered by firms in dealing with suppliers.

We construct an additional variable to capture transaction costs faced by a firm in dealing with its customers, which is defined as the ratio of the total amount of reserves for account

receivables (AR) to total assets (*Reserves of receivables*). The amount of reserves set for potentially non-collectable AR reflects a firm's difficulty in collecting account receivables and failure in predicting its customers' opportunistic behaviors in payments. This variable is thus expected to be positively related to the transaction costs faced by a firm when it is interacting with customers.

Our fourth proxy of transaction costs is defined as the ratio of related party transactions (RPT) scaled by total assets. RPT refers to the deals between two parties who are related by ownership, or personal ties through managers or their family members. As firms with more RPT tend to rely less on market transactions, it is reasonable to expect that these firms tend to face less transaction costs in their operations.

Our fifth variable to capture firms' transaction cost is firms' competitiveness (PCM), defined as sales minus the cost of goods sold (COGS) and SGA divided by sales (Ahern, 2012). A more competitive firm tends to have higher bargaining power vis-à-vis its business partners than a less competitive firm. As such, its business partners are more likely to provide reliable information before transactions and less likely to engage in opportunistic activities after transactions. The weakened adverse selection and moral hazard problems tend to reduce the transaction costs.

The occurrence of litigation incidence is a de facto indicator of the difficulties involved in designing and enforcing contracts. We thus expect that firms with higher litigation risk tend to face high transaction costs in dealing with their stakeholders. Our sixth proxy for transaction costs faced by a firm, *Litigation Risk*, is set at one if a firm experienced more

lawsuits than its industry median in the past three years.<sup>7</sup>

Williamson (1988) predicts that firms with lower transaction costs tend to rely more on debt financing. We thus use leverage, defined as total liabilities divided by total assets, to further capture firms' transaction costs. Finally, firms have been doing business with their business partners since it was established. The older a firm, the more information shared between the firm and its business partners. We therefore employ the variable of firm age, defined as the natural logarithm of the number of years since a firm has been established, as our final proxy of transaction costs faced by a firm.

We use two dummies to capture the incentive of firms to engage in entertainment activities in order to obtain advantageous outcome in non-market-based transactions with stakeholders such as governments and state-owned banks. The first one is the type of ownership (*SOE*), set at one if a firm is controlled by a government agency or a state-owned entity. The second one is political connectedness, set at one if the CEO or board chair of a firm is or was a government bureaucrat (Fan et al., 2007; Calomiris, Fisman, and Wang, 2010). It is well-known that governments and state-owned banking sector favor SOEs and firms with political connectedness (Fan et al., 2007; Calomiris et al., 2010; Firth et al., 2009). The effects of such favoritism on the incentive to engage in entertainment activities are theoretically uncertain. On the one hand, SOEs and firms with political connectedness might alleviate these firms' need to entertain the bureaucrats because they are already protected and favored by bureaucrats due to its ownership and political connections. On the other hand, the

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<sup>7</sup> The empirical results throughout the paper are qualitatively the same if we construct this variable using litigation records in the past four years or two years. Our data does not classify opponents in court into different types of stakeholders. For same cases, it is very difficult to manually classify them as the relationship between defendant and plaintiff in some lawsuits is very complicated. For instance, a firm could be a third party in a case as it provided some guarantee for one party in a certain transaction, or it might play both roles (seller and buyer) at the same time.

ownership and personal relations of these firms create channels for firms to effectively contact and then entertain the bureaucrats. As a result, these firms tend to enjoy greater effectiveness or better technology in entertaining and consequently invest more in this kind of activities.

### *B. Control Variables*

Managers and employees of firms may simply reimburse some expenses of their personal consumptions as a part of BEE. Thus, BEE may also reflect the severity of agency problems in firms. We therefore introduce a set of variables to capture the role of corporate governance in determining BEE. First, we use three variables to capture the quality of board of directors: *Fraction of outside directors* (the sum of independent directors and unpaid directors divided by total number of board directors), *Duality* (taking one if CEO and chairman are the same person, and zero otherwise), and *Board Size* (defined as the logarithm value of the number of board directors). These board characteristics have been shown by prior studies to be systematically related to the effectiveness of corporate boards in mitigating agency problems (e.g., Weisbach, 1988; Rosenstein and Jeffrey, 1990; Liu and Lu, 2007; Nguyen and Nielsen, 2010). Second, four variables are used to capture a firm's ownership structure because ownership helps to align the incentives of various corporate decision makers so as to enhance firm value (Jensen and Meckling, 1979; Lemmon and Lins, 2003; Sun and Tong, 2003). The ownership variables include *largest shareholder's ownership*, *managerial ownership*, *mutual funds' ownership*, and the ownership concentration ratio measured as the Herfindal index for the 2<sup>nd</sup> to 10<sup>th</sup> largest shareholders (*Herfindal index (2-10)*). In addition, we include a variable to capture managerial compensation, defined as the ratio of the total remuneration of the top

three executives divided by total assets (*Remuneration*), because effective managerial compensation can mitigate managerial agency problems by aligning their interests with those of shareholders.

We also include three other firm characteristics including firm size, book-to-market ratio and cash availability. Firm size is defined as the natural logarithm of market value (*lnMKV*). Book-to-market is to capture firms' growth opportunity, which is computed as the natural log of book-to-market ratio (*lnB2M*). Cash availability is included because the firms with more cash should have a greater capacity to spend more on BEE. As *PCM* is highly correlated with ROA (0.61, net income divided by total assets), we do not include firms' profitability as an additional control variable. In addition, an index indicating the market development of a province is added to control for regional effects, which is obtained from Fang and Wang (2011) and widely used in the prior Chinese studies (e.g., Jiang, Lee, and Yue, 2010). Finally, a set of year and industry dummies are used to capture the year and industry fixed effect.

### *C. Additional Control Variables for Disclosure Decisions*

Since the disclosure of BEE is voluntary, we adopt the Heckman two-stage model to correct the self-selection bias when investigating the determinants of BEE. Specifically, we fit a model of disclosure decision and use the estimates to construct an inverse Mills' ratio (*IMR*). The *IMR* is then included as an additional explanatory variable to correct the self-selection bias. We also correct this bias when we examine effects of BEE on corporate outcomes in the next section.

In our model of disclosure decisions, we introduce three additional variables in order to meet the exclusion restriction of the Heckman two-stage model. As displayed in Panel A in

Table B2, firms listed in the GME market in Shenzhen Stock Exchange are the most likely to disclose BEE, while those in Shanghai Stock Exchanges have the lowest disclosure rates. We thus construct two dummies, set at one for firms listed in the GME market and for firms listed on the Shanghai Stock Exchange respectively. Panel A in Table B2 also shows that the disclosure rate in the early years in our sample period is lower. We thus split our sample firm into two equal subsamples by their listing year and use dummy variable of one to denote the firms listed in the early years (*Early listers*) and zero otherwise. We include these three additional variables, together with the other explanatory variables that we use to explain the variation in BEE (except for the variable of *firm age* as it is highly correlated with *Early listers*), to fit the disclosure decision.

### 3.2 Determinants of BEE

In our empirical analysis, BEE is scaled by total assets in percentage. We do not use sales to scale BEE as entertainment with non-market stakeholders like governments and creditors will not directly generate sales. Dividing BEE by sales thus may not be appropriate. Moreover, most of corporate outcomes that we explore are normalized by total assets like ROA. Scaling BEE by total assets will make the interpretation of the results easier.

To construct *IMR*, we first estimate the disclosure decisions using a probit model and report the results in Column 1 in Table 2. The dependent variable is set at one if a firm has disclosed its BEE in a given year and zero otherwise. All explanatory variables are measured concurrently so that we can keep as many observations as possible in the following tests.<sup>8</sup> As expected, early listers and firms listed in Shanghai Stock Exchange are indeed less likely to

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<sup>8</sup> The results throughout the paper are qualitatively the same if we use one year lagged explanatory variables.



disclose BEE. The coefficient of GME Market is in predicted sign, but insignificant.

Columns 2 to 3 report the estimates of the determinants of BEE using one year lagged explanatory variables. Column 2 presents results with year and industry fixed effects, while Column 3 further includes the firm fixed effect. As we can see, the coefficients of almost all explanatory variables constructed to capture the transaction costs between firms and their stakeholders are statistically significant in predicted signs in Column 2. Specifically, firms with greater customer-base and supplier-base concentration, less reserve ratio of AR, lower litigation risk, higher leverage, older and more competitiveness, tend to have lower BEE. These results suggest that a part of BEE might be used to mitigate transaction costs in dealing with different stakeholders. Compared to private firms, SOEs tend to have more BEE. Firms with political connectedness also tend to have higher BEE, but it is not statistically significant.

Among our variables of corporate governance, shares held by the largest shareholders have significantly negative effect on BEE, while the coefficients of board size are significantly positive. These results suggest that the agency problem might also play a role in explaining BEE. However, mutual funds' ownership and managerial compensation have significantly positive effect on BEE, which is not consistent with the agency hypothesis.

Column 3 presents the estimates with the firm fixed effect. The coefficients of some variables become statistically insignificant, which are not surprising because these explanatory variables and BEE are highly persistent over the years (the correlation between BEE and its one year lag is 0.86). Nevertheless, the estimates for several variables are still qualitatively similar to those in Column 2. For example, firms with greater customer-base

concentration, lower litigation risk, less reserve ratio and higher leverage tend to have lower BEE. Two interesting results are noteworthy. The coefficient of the fraction of outside directors becomes significantly negative, which suggests that BEE is reduced when a firm has more outside directors on its board. A possible explanation is that outside directors might actually curb the abused BEE by managers such as their personal consumption. The coefficient of political connectedness also gets significantly positive, which suggests that firms tend to have higher BEE when a newly appointed CEO or board chair is or was a government bureaucrat.

[Table 2 here: Determinants of Disclosure Decision and BEE]

## **4. BEE and Firm Performance**

### *4.1 Identification Strategy*

The challenge to identify the causal effect of BEE on accounting performance is that BEE is endogenous. Results from an ordinary least squares model could thus be biased. Besides using one year lagged explanatory variables, we employ an instrumental variable method to mitigate this concern. Following similar arguments in Nevo (2001) and Cai et al. (2011), we use the median BEE of other firms within the same industry at two-digit level in a given year as the instrument. Firms within the same industry share some common but unmeasurable factors that affect BEE such as specific product attributes and industry regulations. Therefore, the industry median BEE is correlated with firm BEE but less likely affect other firm outcomes directly, except indirectly through BEE.<sup>9</sup> Indeed, the firm BEE is significantly related to the industry median BEE. The industry median BEE alone can explain about 12.19%

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<sup>9</sup> Similarly, Nevo (2001) argues that other regional average prices can serve as an instrument for the city-level price as both of them respond to the product's common marginal costs. Cai et al. (2011) also use the average entertainment and travel costs of other firms within the same city and industry as an instrument for a firm's costs.

of the total BEE variation, which is more than 45% of the total explained variation in BEE in Table 2. Therefore, the industry median BEE is a strong instrumental variable.

Our baseline model specification that examines the effect of BEE on corporate outcomes is as follows:

$$Outcomes_{i,t+1} = \alpha + \beta \times BEE_{i,t} + \gamma \times Controls_{i,t} + \varepsilon_{i,t} \quad (1)$$

where *Controls* refer to all independent variables including *IMR*, year and industry dummies in explaining the determinants of BEE. We use the total assets at year *t* as the deflator when the outcome is scaled by total assets. An advantage of this specification is that we can interpret the coefficient of BEE as one RMB increase in BEE will lead to  $\beta$  RMB increases in the outcome of interest.

#### 4.2 Main Results

We construct two variables to measure firm accounting performance: operating efficiency and profitability. Operating efficiency is defined as the ratio of sales to total assets, while profitability is measured as ROA. Table 3 presents the estimates of the effect of BEE on each proxy of firm performance in Panels A and B, respectively. The model specifications in both panels are similar. Column 1 in both panels reports the OLS estimates with industry and year fixed effects, while Column 2 adds the one year lagged dependent variable. In Column 3, we further include the firm fixed effect to control for any unobservable time-invariant firm characteristics that would affect firm performance. Column 4 displays the IV estimates. Since the industry median BEE is highly persistent, we do not control for the firm fixed effect in the IV estimation.

As expected, the coefficients of BEE are all significantly positive throughout all four

columns in Panels A and B. These results indicate that BEE indeed improves firm performance. The effect of BEE on firm performance is not only statistically significant, but also economically prominent. Taking the lowest coefficient of BEE in Column 2 in both panels as examples, one RMB increase in BEE will bring firm 14.7 RMB in sales and 2.0 RMB in net profits.

Panel C in Table 3 relates BEE with concurrent firm valuation, measured as the ratio of the sum of market value of equity and book value of total liabilities at the end of April in year  $t+1$  over total assets at year  $t$  (Tobin's Q). As we can see, the coefficients of BEE are significantly positive throughout all four columns, which indicate that high BEE firms tend to have high firm valuation. The estimates in Column 2 suggest that one RMB increase in BEE will be associated with 19.4 RMB more in firm valuation.

[Table 3 here: BEE, Firm Performance and Valuation]

## **5. BEE, Future Stock Returns and Unexpected Future Earnings**

So far, we have documented that BEE can improve firm performance. One may wonder whether the earnings information contained in BEE has been fully comprehended by market participants including investors and analysts. In this section, we investigate whether BEE can predict future stock returns and unexpected future earnings.

### *5.1 Future Stock Returns*

Table 4 presents the predictability of BEE on future stock returns. In each year between 2004 and 2012, we sort firms into quintile portfolios based on BEE for each industry at two-digit level. We then compute future returns beginning from May 1 (year $t+1$ ) through April 30 (year  $t+2$ ). Four factor-mimicking portfolios (MKT, SMB, HML, UMD) are

constructed in the same manner as Fama and French (1993) and Carhart (1997), but using the Chinese data. The risk free rate is defined as the concurrent demand deposit rate.

In Panels A and B in Table 4, all stocks are equal-weighted and value-weighted by tradable market capitalization, respectively. In each panel, alphas derived from the CAPM, Fama-French (1993) three-factor, and Carhart (1997) four-factor models are reported successively. The patterns of these portfolios' performance in both panels are largely similar, and it is monotonically increasing in Panel B. The top and bottom portfolios have the highest and lowest alphas. A trading strategy by longing the group of high BEE quintile portfolio and shorting the group of low BEE quintile portfolio can significantly generate profits across all models. For instance, the Carhart four-factor model indicates that this hedged strategy can earn 5.244% (=0.437%\*12) and 8.736% (=0.728%\*12) annual return for equal-weighted and value-weighted method, respectively.

[Table 4 here: BEE and Future Stock Returns]

## 5.2 Unexpected Future Earnings

Following Mayew and Venkatachalam (2012), we relate BEE to unexpected future earnings to investigate whether BEE contains novel information about earnings that has not been realized by analysts. Specifically, unexpected future earnings (UE) are defined as the analyst forecast error (actual earnings per share minus the median earnings forecast from -12 months to two days prior to the earnings announcement) scaled by the stock price two days prior to the earnings announcement. We use the following model specification to examine the effect of BEE on unexpected earnings:

$$UE_{i,t+1} = \alpha + \beta \times BEE_{i,t} + \gamma \times SD\_FEPS_{i,t+1} + \delta \times Controls_{i,t} + \varepsilon_{i,t} \quad (2)$$

where  $SD\_FEPS$  is the standard deviation of forecasted earnings per share from -12 months to two days prior to the earnings announcement. *Controls* refer to the same set of variables in equation 1. As only a part of public firms have been covered by analysts, the sample size is reduced to 4613 observations in this exercise.

Table 4 presents the estimates for equation 2. Column 1 reports the estimates using the OLS model, while Column 2 presents the IV estimates. As expected, the coefficients of BEE in both columns are significantly positive, indicating that BEE has a significantly positive effect on unexpected future earnings.

[Table 5 here: BEE and Unexpected Future Earnings]

## **6. BEE and Benefits from Different Stakeholders**

To explore how BEE improves firm performance, we look deeper by focusing on four main types of outside stakeholders including customers, suppliers, governments, and creditors in this section. Based on the nature of transactions, we group our analyses into two categories: market-based transactions and non-market-based transactions. It is worthy to note that the benefits we document below might be only a part of benefits derived from each stakeholder.

### *6.1 Benefits from Market-based Transactions*

#### *A. Trade Credit with Customers and Suppliers*

We have documented that BEE can improve sales, which is one of the benefits from entertaining customers. We now look at the quality of trade credit extended to customers, which is another angle to further investigate whether BEE can benefit from entertaining customers. For the benefit from suppliers, we focus on the effect of BEE on obtaining trade

credit from them. We center our analyses on this angle because trade credit is widely adopted in business transactions but the payments of trade credit suffer heavily from opportunistic behavior as no collateral is usually set in place to serve as an effective enforcement device. Previous studies have shown that improved trust and information sharing help firms to improve the quality of trade credit and also facilitate its utilization (e.g., Smith, 1987; Petersen and Rajan, 1997).

To cover potentially non-collectible account receivables (AR), firms are required to set up a particular accounting item titled as the provision of bad AR to record their reserves for AR. As the reserve ratio is lower for new AR, more new AR at year  $t+1$  would automatically lower overall reserve ratio of AR at year  $t+1$ . To avoid any potential bias due to newly extended AR, the quality of AR is defined as the ratio of provision for bad long-term AR to total long-term AR (*Reserve ratio of AR*).<sup>10</sup> The reserve ratio of AR is essentially an expected default rate of long-term AR. The trade credit from suppliers is defined as the ratio of account payables AP at year  $t+1$  divided by total assets at year  $t$ . We expect BEE to have negative effect on the reserve ratio of AR and positive effect on obtaining trading credit.

Table 6 reports the estimates. The dependent variables in Columns 1 - 2 and 3 - 4 are *Reserve ratio of AR* and trade credit from suppliers, respectively. Columns 1 and 3 present the OLS estimates with the industry and year fixed effects, while Columns 2 and 4 display the IV estimates. As expected, the coefficients of BEE in all four columns are statistically significantly with predicted signs, which suggest that BEE can improve the quality of AR and acquire more trade credit from suppliers.

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<sup>10</sup> All the empirical results are essential the same if we define the quality of AR as the ratio of provision for bad AR to total AR.

The economic magnitudes of both effects are moderate but still meaningful, which is reasonable given that BEE is at the aggregate level and these two effects just capture a part of benefits from customers and suppliers. The estimates in Column 1 imply that one standard deviation increase in BEE will improve the quality of long-term AR by 2.00% ( $=0.077*0.26$ ), which is about 5.41% ( $=2.00\%/0.370$ ) of the average reserve ratio of the long term AR. Column 3 indicates that one RMB increase in BEE can help firms acquire 5.5 RMB more trade credits from suppliers.

[Table 6 here: BEE and Trade Credit with Customers and Suppliers]

To explore further whether the effect of BEE on improving the quality of AR (acquiring more trade credit from suppliers) is due to the migration of transaction costs between firms and their customers (suppliers), we next examine whether the effect is stronger for firms with higher transaction costs in dealing with their customers (suppliers). Our first proxy to capture the transaction costs faced by firms in dealing with customers (suppliers) is customer-base (supplier-base) concentration. We sort all firms by one of these two proxies into terciles for each year. We drop the middle tercile and define the top and bottom tercile as the low and high transaction costs subsamples. Unless otherwise specified, all splitting procedure throughout the paper will follow this cutoff when the sorting variable is a continuous one. We also partition firms into high-tech and low-tech industries. Relative to low-tech firms, high-tech firms tend to face high transaction costs.<sup>11</sup>

Panels A and B in Table 7 report the subsample estimates for the effect of BEE on improving the quality of AR and acquiring more trade credit from suppliers, respectively. For

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<sup>11</sup> High-tech industries include Information Technology, Electronic, Pharmaceutical Products and Machinery, while low-tech industries are comprised of Utilities, Furniture, Apparel, Transportation, Construction, Food, Printing and Agriculture.



brevity, we only report the coefficients of BEE. At the bottom of each panel, a Wald test is reported to examine the equality of the coefficients of BEE between the two subsamples. Results in Panel A indicate that the effect of BEE on the quality of AR is stronger for the subsample with high transaction costs (low customer-base concentration or high-tech industries), while the difference in the coefficients of BEE between two subsamples is statistically insignificant when using customer-base concentration to proxy for transaction costs. Estimates in Panel B show that the effect of BEE on AP is significantly stronger for the subsample with high transaction costs for both proxies of transaction costs. Overall, these results suggest that BEE do help firms mitigate transaction costs in dealing with customers and suppliers.

[Table 7 here: Transaction Costs, BEE and Trade Credit with Customers and Suppliers]

#### *B. Litigation Incidence with Stakeholders*

One of the most costly ways for both trading counterparties to solve conflicts is to sue each other in court. The occurrence of legal disputes exhibits the disagreements on certain issues about transactions between trading counterparties due to the failure in coordinating and enforcing contracts. A better contract might be devised beforehand to avoid potential disagreements over transactions, and these disagreements can be alleviated during the implementation of contracts if trading counterparties understand each other better. Therefore, we expect BEE to lower litigation incidence.<sup>12</sup>

Table 8 presents the analyses for litigation incidence. The dependent variable is a dummy

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<sup>12</sup> Whether a firm won the case in court is a more complicated question and it is affected by many factors such as the characteristics of the other party in court. Our data set does not include information on the characteristics of the other party in court and many of them are unlisted firms. In addition, we have very little information on the characteristics of the case. We thus do not examine the effect of BEE on the winning rate in court. Interested readers could check Lu, Pan and Zhang (2012), who examine the determinants of winning a legal dispute in court.

variable, which is set at one if a firm experiences any litigation dispute with other firms in the next year, and zero otherwise. Columns 1 and 2 report the probit and IV probit estimates of the likelihood of getting a lawsuit. As expected, the coefficients of BEE in both columns are significantly negative, which suggest that BEE indeed lower litigation incidence. The economic significance is also meaningful. Taking the estimates in Column 1 as an example, one standard deviation increase in BEE will lower litigation incidence by 0.67%, which is about 7.13% of the average litigation incidence.<sup>13</sup>

Since firms could have lawsuits with any of their stakeholders, we use related party transaction to proxy for the aggregate transaction costs faced by firms with all of their stakeholders. The splitting procedure is the same as before. We expect that the effect of BEE on reducing litigation incidence is stronger for firms with less related party transactions as they rely more on the external market. The last two columns in Table 8 report the subsample estimates. We use a linear probability model rather than the probit model as it is meaningless to directly compare the relative size of two coefficients from the probit model (Allison, 1999). The coefficients of BEE are only significantly negative in the subsample with low related party transactions, which further confirms that BEE can benefit firms by reducing transaction costs confronted by firms in dealing with their stakeholders.

[Table 8: BEE and Litigation Incidence]

## 6.2 Benefits from Non-market-based Transactions

### A. Subsidy from Governments

We investigate the effects of BEE on interactions with governments by focusing on

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<sup>13</sup> The marginal effect of BEE when all other variables equal to their means is  $-0.0259$ ;  $0.67\% = -0.0259 * 0.26$ ;  $7.13\% = 0.67\% / 0.094$ .

government subsidy, which is usually subject to applications and assessed by government agents.<sup>14</sup> As government subsidy data is only available since 2008, the sample size in this exercise is reduced to 6,342. Columns 1 and 2 in Table 9 present the OLS and IV estimates. As a part of subsidy from local governments, we further control for the provincial fixed effect. The dependent variable is the amount of government subsidy received at year  $t+1$  scaled by total assets at year  $t$ . As expected, the coefficients of BEE in both columns are significantly positive, which suggest that high BEE firms tend to get more subsidies from governments. The magnitude of the effect of BEE on subsidy is quiet large, given that BEE here is an aggregate expenditure for a firm's all business entertainment. Taking the results in Column 1 as an example, one RMB increase in BEE will bring firm 0.517 RMB more government subsidy.

[Table 9 here: BEE and Benefits from Non-market-based Transactions]

We expect that the benefit of BEE on securing government subsidy is stronger for SOEs, politically connected firms and large firms because these firms are able to have better access to key decision makers and enjoy more favorable political status than their counterparts. As a result, we expect these firms tend to be more effective in entertaining bureaucrats so as to achieve favorable outcomes. We also expect the effect to be stronger if BEE incurred when government officials are in their early tenure. The reason is that officials may not have established their own patronage and networks in their early tenure and thus have more room to offer favors to various new constituents (Macey, 1993), or they tend to have less solid political power in their early tenure and therefore subject to stronger influences from

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<sup>14</sup> Government subsidy is the only systematic information that we can find, which is at the discretion of government officials. Contracts from governments could be another good angle to examine how BEE affects the transaction with governments. To our best knowledge, this information is not available for Chinese public firms.

lobbying groups (Rausser and Zusman, 1998). In addition, BEE could also serve as information intermediary as officials and firms tend to suffer more information problem in officials' early tenure. We construct one variable to capture the change of governments. We focus on governments at the prefecture level rather than the provincial or national level because it will give us more variation in turnover years as the turnover of the provincial and central government tend to be more clustered. Unlike the fixed tenure for national leaders, there is no fixed tenure for the mayor and secretary of the communist party of China at the prefecture level. We define the early (late) period as years that both the mayors and the party secretaries are in the first two years (third to fifth year) of their tenure in the office.

Panel A in Table 10 reports the subsample estimates. As we can see, the effect of BEE on subsidy is significantly stronger for SOEs, large firms and in the early period of a new government administration. The effect of BEE tends to be bigger for firms with political connectedness than firms without such connectedness, although it is statistically insignificant. Therefore, these results largely support the notion that BEE can benefit firms by securing favors from governments.

[Table 10 here: Favoritism, BEE and Benefits from Non-market-base Transactions]

#### *B. Collateral Requirement on Bank Borrowings*

It is well-known that loan officers enjoy substantial discretion in their decision-making because the risk assessment of firms requires not only hard information but also soft information (Berger et al., 2005; Agarwal and Hauswald, 2010). The reliance on soft information opens the door for entertainment activities to influence lending decisions, because it can facilitate the sharing of soft information. For example, Agarwal and Hauswald

(2010) find that borrower proximity is related to the utilization of soft information, and Engelberg et al. (2012) find that board members with good personal connections with banks tend to pay low interest rate of bank borrowings.

Entertainment activities can also influence lending decisions because of the agency problems of loan officers (Udell, 1989; Agarwal and Ben-David, 2014). Given the divergence in interests between loan officers and banks, it is possible for loan officers to provide better terms to the borrowers who have made them happy through entertainment activities. We expect that entertainment activities may have a greater impact on loan decisions in China because the major banks in China remain partially state-owned, even the largest ones that have been listed on the stock exchanges in China and Hong Kong. Consistent with such an ownership structure, governments still use the banks to serve political and social objectives (e.g., Jin and Qian, 1998; Firth et al., 2009; Song, Storesletten, and Zilibotti, 2011). The presence of non-economic objectives provides loan officers with even greater degree of discretion in their decision-making.

We investigate the effect of BEE on the transactions with creditors by focusing on the required collateral on bank borrowings, which is defined as the ratio of collateralized loans divided by total loans at year  $t+1$ . We expect that entertainment activities can reduce the required collateral on bank borrowing, either because the activities can reduce the information asymmetry between borrowers and thus the default risks of borrowed as perceived by the banks, or the activities can successfully influence the lending decisions of loan officers. Data on collateral on bank borrowing is available since 2006 and it is a voluntary disclosed item. We only successfully find 4991 firm-year observations after

merging with our main dataset.

To control for the default risk, we introduce an additional control variable, the Z-Score to control for potential default rate. Following Altman (2005), we use the following Z-Score formula for emerging markets to measure the expected default rate:

$$Z\text{-Score}_{i,t} = 6.56 \times X_{1,i,t} + 3.26 \times X_{2,i,t} + 6.72 \times X_{3,i,t} + 1.05 \times X_{4,i,t} + 3.25 \quad (3)$$

where  $X_1$  to  $X_4$  are defined as working capital, retained earnings, operating income and book value of equity scaled by total assets, respectively. The higher the Z-Score, the less likely a firm will default. As a long-term loan is more likely to be required for collateral than a short-term loan as the former is riskier to banks, we also add the ratio of long term loan to total loan as an additional explanatory variable.

Columns 3 and 4 in Table 9 present the OLS and IV estimates. As expected, the coefficients of BEE in both columns are significantly negative, which suggest that high BEE firms tend to have low requirement on the collateral of bank borrowings. The coefficients of the two new explanatory variables are indeed statistically significant with predicted signs in Column 3, but the coefficient of Z-Score in the IV estimates becomes insignificant. Using the results in Column 3 as an example, one standard deviation in BEE at the aggregate level can reduce 1.43% ( $=0.055 \times 0.26$ ) collateral on bank borrowings, which is about 3.45% ( $1.43\%/0.415$ ) of the average collateralized ratio. The economic magnitude of BEE on lowering collateral requirement of bank borrowings is not that significant, which is reasonable because the disclosed BEE is at the aggregate level.<sup>15</sup>

The previous literature has documented that state-owned bank sectors favor SOEs and

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<sup>15</sup> Getting new loans and/or lowering interest rate of borrowings are other benefits that a firm can get from creditors. Unfortunately, we are unable to estimate the amount of new loan granted in each year. Interest rate on bank borrowings is also not mandatory to disclose.

politically connected firms (e.g., Jin and Qian, 1998; Khwaja and Mian, 2005; Firth et al., 2009; Song et al., 2011), we thus expect that the benefit of BEE on reducing collateral requirement on bank loans is stronger for SOEs and politically connected firms. Moreover, we expect BEE to generate greater benefits for financially constrained firms because the lending decisions relating to these firms require more soft information and personal judgments than financially healthy firms. Meanwhile, governments in China tend to use state-owned banks to bail out poorly performing firms. The priority of governments may also increase the effectiveness of entertaining activities in securing favors from the banking sector. We use two methods to define whether a firm is financial constrained. The first one is the Z-score that we defined before. For each year, we sort firms into terciles by the Z-score. Firms in the top (bottom) tercile are financial unconstrained (constrained) firms. The second proxy is a dividend payout policy in a given year. Firms paying dividends are regarded as unconstrained ones, while firms not paying dividend are constrained ones.

Panel B in Table 10 presents the subsample estimates. As expected, the effects of BEE on lowering collateral requirement are stronger for SOEs. The effect tends to be bigger for firms with political connectedness than those without such connectedness, while it is statistically insignificant. These results seem consistent with the well-documented favoritism enjoyed by these firms in China.

The estimates in the last four columns indicate that the effect of BEE on lowering collateral requirement is stronger for financial constrained firms. There are two potential mechanisms leading to the observed results. On one hand, financial constrained firms tend to face higher default risk and entertainment activities can help to reduce the information

asymmetry and mitigate the risk perceived by loan officers. On the other hand, the higher returns of BEE for these firms may be due to state-owned banks' special preference to bail out the poorly performing firms, making the entertainment activities more effective in influencing the decisions of loan officers.

## **7. BEE and Corporate Governance**

So far, we have documented that BEE can benefit firms in interacting with different stakeholders, which improves firm performance and value. As BEE could be inflated by managers for their personal consumption, one may wonder how corporate governance would mediate the effect of BEE on corporate outcomes. To test the role of governance, we repeat all previous analyses but using subsamples of firms with strong versus weak governance.

In the absence of a G-index for Chinese listed firms, we turn to more traditional measurement of governance quality. A large body of studies since at least 1980s document evidence to support that outside directors can improve corporate governance (e.g., Weisbach, 1988; Rosenstein and Jeffrey, 1990; Nguyen and Nielsen, 2010). With Chinese setting, previous studies such as Liu and Lu (2007) also reach the same conclusion. In the determinants of BEE, we have found that an increase in outside directors can lower the amount of BEE, which empirically corroborates that outside directors can improve governance quality. Therefore, we use the fraction of outside directors to proxy for governance quality.<sup>16</sup> As before, we sort all firms into terciles by the fraction of outside directors for each year. Strong (weak) governance subsamples include firms in the top

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<sup>16</sup> Outside directors are unpaid directors plus independent directors. Unpaid directors are representatives of majority shareholders sitting on the board and they get paid by majority shareholders. Given CSRC (equivalent to SEC in the U.S.) mandate the quota of independent directors (at least one third of total board directors) and there is little cross-sectional variation in the percentage of independent directors. If we define outside directors as unpaid directors only, all empirical results throughout this study remain unchanged.



(bottom) tercile.

Panel A in Table 11 repeats the analyses in Table 3 with the same model specification as Column 1 in each panel. As expected, the effects of BEE on Asset Turnover and ROA are significantly stronger for the subsample with strong governance. The last two columns in Panel A report the subsample results for Tobin's Q. The effect of BEE on Q is bigger for strong governance subsample, while the difference in the effects of BEE on Q between the two subsamples is not significantly different from zero.

Panel B repeats the analyses in Table 4. We only report the results of the Carhart four-factor alphas for brevity. These results indicate that the same hedged strategy as before tends to be more profitable among firms with strong governance. The subsample results for Table 5 are presented in the first two columns in Panel C. As expected, the significant effect of BEE on unexpected future earnings only lies in firms with strong governance. Columns 3 to 6 in Panel C repeat the analyses in Table 6. These estimates suggest that the effects of BEE on improving the quality of AR and acquiring trade credits from suppliers are stronger for better governance subsample.

In Panel D, we repeat analyses in Tables 8 and 9. As we can see, the effect of BEE on government subsidy is stronger for the better governance subsample. The coefficient of BEE on collateral requirement is only significant for the better governance subsample, while the difference in the coefficients of BEE in strong and weak governance subsample are not significant. In the last two columns, the effect of BEE is slightly bigger for strong governance firms, while neither of them is statistically significant and their difference is also insignificant.

Overall, the results in Table 12 largely confirm that the benefit of BEE is stronger for firms with strong governance. Although we do not find a net detrimental effect of BEE on the corporate outcomes we have considered, the stronger positive effect for firms with better governance structure may suggest that BEE also suffers from agency problem.

[Table 10 here: Corporate Governance, BEE and Benefits from Different Stakeholders]

## **8. Conclusion**

Entertaining business stakeholders is one of long-standing and prevalent corporate activities. Given its history, magnitude and discretionary nature, it is important to understand why firms entertain their business stakeholders and what real impacts it may have on firms. This paper performs the first systematic study on the determinants and impacts of BEE on firm performance and other corporate outcomes.

We find that BEE can improve future firm performance such as operating efficiency and profitability. Furthermore, the performance implications of BEE have not been fully anticipated by investors and analysts. We further find that BEE can help firms improve the quality of trade credit, acquire trade credit from suppliers, secure more government subsidy, lower requirement on collateral for bank borrowings, and reduce litigation incidence. Further analyses support two channels that drive these outcomes: that is, mitigating transaction costs in market-based transactions and securing favors in non-market-based transactions. In addition, we find that the effects of BEE are weaker in firms with a weak corporate governance structure. Overall, our study suggests that entertainment activities can improve firm performance, though it may also suffer from agency problems.

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### Appendix A. Variable Definitions

Variable	Definition and Data Source
BEE(Dummy)	Disclosure decision, a dummy variable equals one if a firm disclosed business entertainment expenditure in a given year.
BEE	The ratio of business entertainment expenditure to total assets in percentage. Winsorized at 1% and 99% levels. Source: Manual collection.
<i>Corporate Outcomes</i>	
Asset Turnover	Sales at year t+1 divided by total assets at year t. Winsorized at 1% and 99% levels. Source: CSMAR database.
ROA	Net income at year t+1 divided by total assets at year t. Winsorized at 1% and 99% levels. Source: CSMAR database.
Tobin's Q	Tobin's Q, which is defined as the ratio of the sum of the market value of equity and the book value of total liabilities at the end of April in year t+1 over total assets at year t. Winsorized at 1% and 99% levels. Source: CSMAR databases.
UE	Unexpected future earnings are measured as the analyst forecast error scaled by the stock price two days prior to the earnings announcement. The Forecast error is defined as the actual earnings per share minus the median earnings forecast from -12 months to two days prior to the earnings announcement. Winsorized at 1% and 99% levels. Source: CSMAR database.
Reserve ratio of AR	Total reserves for long-term account receivables divided by total long-term account receivables. Winsorized at 1% and 99% levels. Source: CSMAR database.
AP/TA	Account payables at year t+1 divided by total assets at year t. Winsorized at 1% and 99% levels. Source: CSMAR database.
Subsidy/TA	Government subsidy at year t+1 divided by total assets at year t in percentage. Winsorized at 1% and 99% levels. Source: iFind database.
Collateral	Collateralized bank borrowings divided by total bank loans. Winsorized at 1% and 99% levels. Source: CSMAR database.
Litigation incidence	A dummy variable equals one if a firm has any lawsuits in the next year, and zero otherwise. Source: Wind database.
<i>Other Firm Characteristics</i>	
Early Listers	A dummy variable equals one if a firm was listed in the early years among all public firms for each year, and zero otherwise.
GME market in Shenzhen SE	A dummy variable equals one if a firm is listed at the GME market in Shenzhen Stock Exchange, and zero otherwise.
Shanghai SE	A dummy variable equals one if a firm is listed in Shanghai Stock Exchange, and zero otherwise.
Customer-Base Concentration	Fraction of sales to top five customers in a given year. Source: GW database.
Supplier-Base Concentration	Fraction of procurements from top five suppliers. Source: Source: GW database.
RPT/TA	The ratio of total transactions with related parties to total assets. Winsorized at 1% and 99% levels. Source: CSMAR database.
Litigation risk	A dummy variable equals one if a firm experienced more lawsuits than its industry median in the past three years, and zero otherwise. Source: Wind database.
Reserves of receivables	Total reserves for account receivables divided by total assets in percentage. Winsorized at 1% and 99% levels. Source: CSMAR database.

SOE	A dummy variable equals one if a firm's ultimate controller is a government agency or legal entity controlled by governments, and zero otherwise. Source: CSMAR database.
Political connectedness	A dummy variable equals one if the CEO or board chair of a firm is or was a government bureaucrat following Fan et al. (2007) and Calomiris et al. (2010). Source: Manual collection.
Leverage	Total liabilities divided by total assets. Winsorized at 1% and 99% levels. Source: CSMAR database.
Firm age	Natural logarithm of the number of years since a firm is established. Source: CSMAR database.
PCM	Price cost margin, defined as sales minus cost of goods sold (COGS) and selling, general and administrative expenses (SGA), divided by sales. Winsorized at 1% and 99% levels. Source: CSMAR database.
Fraction of outside directors	The proportion of outside directors defined as the sum of unpaid and independent directors. Source: CSMAR database.
Duality	A dummy variable equals one if a firm's CEO and chairman are the same person, and zero otherwise. Source: CSMAR database.
Board Size	Natural logarithm of number of board directors. Source: CSMAR database.
Largest shareholder's ownership	Fraction of largest shareholder's ownership. Source: CSMAR database.
Managerial ownership	Fraction of shares held by the managers. Source: CSMAR database.
Mutual funds' ownership	Fraction of shares held by mutual funds. Source: CSMAR database.
Herfindahl index (2-10)	Herfindahl index, defined as the sum of the square of the fraction of shares held by the 2nd to 10th largest shareholders. Source: CSMAR database.
Remuneration	The ratio of total remuneration of top three executives divided by total assets in percentage. Winsorized at 1% and 99% levels. Source: CSMAR database.
lnMKV	Natural logarithm of firm market value. Winsorized at 1% and 99% levels. Source: CSMAR database.
lnB2M	Natural logarithm of the ratio of the book value of equity to the market value of equity. Winsorized at 1% and 99% levels. Source: CSMAR database.
Cash availability	Cash and equivalents divided by total assets. Winsorized at 1% and 99% levels. Source: CSMAR database.
Market Development	An annually aggregate index measuring the development of the regional market at the provincial level. The higher this index, the greater regional market development. The latest available data is 2009. We thus use the data of 2009 for the years from 2010 to 2012 in our analyses. Source: Fan and Wang (2011)
SD_FEPS	Standard deviation of forecasted earnings per share from -12 months to two days prior to the earnings announcement. Winsorized at 1% and 99% levels. Source: CSMAR database.
Ratio of long term loan	Long term bank loans divided by total bank loans. Winsorized at 1% and 99% levels. Source: CSMAR database.
Z-Score	Firm financial health, calculated using the formula in Altman (2005). Winsorized at 1% and 99% levels.
IMR	Inverse Mill's ratio constructed using the estimates of the determinants of BEE disclosure decision in Column 1 in Table 2. Winsorized at 1% and 99% levels.

## **Appendix B. Data Collection Procedure**

According to Chinese accounting principles, BEE is a secondary accounting item which may be reported in the notes of accounts of the following three sections: “Management Expenses” and “Sales Expenses” Sections in the Income Statement, and “Other Cash Payments for the Expenses Related to Operating Activities” (hereafter “Other Cash Payments”) section in the Cash flow Statement. For the entries in the Income Statement, BEE is the amount spent on entertainment activities in a given fiscal year, which is listed under management expenses section and/or sales expenses section. During our data collection, we find that some firms report BEE only under the management or sales expenses, which suggest that it may be difficult for some firms to separate BEE into management expenses and sales expenses or it is just not big enough to be listed independently. BEE in the “Other Cash Payments” is the total amount that a firm actually paid for entertainment activities in a particular year. Table B1 below presents a typical example of how data on BEE is extracted from a firm’s annual reports. Three features are noteworthy from this example. First, some expense items are aggregated and listed under the item of “Others”. This item may include BEE if it is not disclosed independently. Thereby, it does not necessarily mean that a firm has spent zero on BEE if it has not been listed separately. Second, a firm may disclose BEE in the last year as a reference at the same time but this may not be the case for all firms in all years. Third, the sum of entertainment expenditure listed under the “Management Expenses” and “Sales Expense” sections should be equal to the amount as reported under the “Other Cash Payments” sections if BEE was paid in a given year including all and only those incurred concurrently. Nevertheless, we find that a few observations with data from these two sources do not match with each other. Panel A in Table B2 presents the distribution of firms with BEE



by year and market.

[Insert Table B1 here]

Based on disclosure practices, we define BEE for a firm in given year using following procedures. Panel B in Table B2 displays the distribution of firms with BEE by year and type of account. We classify all disclosure situations into three types. For Type 1 in Panel B, BEE is disclosed under both sections of “Management Expenses” and “Sales Expenses” in the Income Statement. We take the sum of the amounts as disclosed BEE under both sections as the total BEE. For Type 2, BEE is only disclosed in either one of expenses accounts or “Other Cash Payments” account, we take the disclosed BEE as the total BEE.<sup>17</sup> For Type 3, BEE is only disclosed in the “Other Cash Payments” section in the Cash Flow Statement and one expense account in the Income Statement. We compare them and take the larger one as the total BEE. Our choice is due to the consideration that BEE might be aggregated into the item of “Others” if there is no BEE disclosed under the other expenses account.<sup>18</sup>

To ensure the quality of our data on BEE, twelve graduate students majoring in accounting or finance from two well-known universities in mainland China were split into two groups, who collect the data independently. We then compare the data collected by these two groups of students to identify the inconsistent observations. The students are then required to look into the problematic observations and correct the inconsistencies that have been identified. To further guarantee the quality of the data, one of the coauthors double checked all the data by comparing the numbers with those appeared in the annual reports.

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<sup>17</sup> BEE is normally classified as one of management expenses. Our empirical results throughout the paper remain qualitatively the same if we drop observations of Type 2-2.

<sup>18</sup> In the robustness test, we also take the average of BEE if the sum of BEEs from two expenses account is not equal to the amount listed in the “Other Cash Payments” account, or drop observations of Type 3-2. Our empirical results remain qualitatively the same.

[Insert Table B2 here]

**Table B1. Extract of the Financial Reports with Data on BEE**

Stock code: 002370. Year: 2012. Unit: 1RMB.

Sales Expense		
Items	current year	last year
Wage	2,876,444.99	3,961,576.83
Travel costs	33,937,028.46	30,504,642.02
Transportation costs	7,951,305.48	6,635,643.27
Sales discount costs	2,663,771.16	1,782,702.69
Advertising and promotion costs	227,370.71	424,703.21
Postal costs	180,256.67	234,392.76
Business entertainment expenses	166,525.00	43,357.50
Conference costs	524,796.37	937,453.53
Others	2,706,148.85	1,124,088.17
Total	51,233,647.69	45,648,559.98

  

Management expenses		
Items	current year	last year
R&D	18,681,360.49	14,446,714.93
Wage	14,424,277.08	11,918,789.10
Depreciation and amortization	4,758,692.43	3,726,823.50
Taxes	2,583,811.62	2,340,730.18
Travel costs	994,936.66	2,404,738.81
Vehicle use costs	994,838.23	1,052,120.13
office costs	1,448,245.42	1,091,721.35
Business entertainment expenses	812,989.40	1,125,236.31
Others	1,692,664.06	1,993,460.78
Total	46,391,815.39	40,100,335.09

  

Other Cash Payments for The Expenses Related to Operating Activities	
Items	current year
Travel costs	34,931,965.12
Transportation and postal costs	8,131,562.15
Business entertainment expenses	979,514.40
office costs	1,448,245.42
Vehicle use costs	994,838.23
Advertising and promotion costs	225,870.71
Fine expenses	1,069,701.66
Others	1,784,515.11
Total	49,566,212.80

**Table B2. Distribution of Firms with BEE by Year, Market and Types of Account**

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
<b>Panel A. # Firms with BEE by year</b>										
# Firms with BEE	473	487	550	623	652	1,258	1,555	1,793	1,872	9,263
% Disclosure rate	35.22%	36.32%	39.34%	41.95%	42.15%	76.71%	78.65%	79.55%	77.64%	60.16%
<b>Shanghai Stock Exchange</b>										
# Firms with BEE	278	290	301	317	318	630	654	676	682	4,146
% Disclosure rate	33.90%	35.63%	36.57%	38.29%	38.36%	75.90%	77.12%	76.56%	74.86%	54.65%
<b>Shenzhen stock EX (SME market)</b>										
# Firms with BEE	195	197	249	306	334	596	770	871	891	4,409
% Disclosure rate	37.28%	37.38%	43.30%	46.58%	46.52%	77.00%	78.89%	79.91%	77.82%	63.12%
<b>Shenzhen stock EX (GEM market)</b>										
# Firms with BEE	N.A.	N.A.	N.A.	N.A.	N.A.	32	131	246	299	708
% Disclosure rate						88.89%	85.62%	87.54%	84.23%	85.82%
<b>Panel B. # Accounts disclosed BEE by year</b>										
# Other Cash Payment	460	476	534	590	607	632	728	751	763	5,541
# Management Expense	26	25	42	67	78	1,075	1,394	1,641	1,698	6,046
# Sales Expense	8	9	26	38	47	605	833	1,014	1,051	3,631
Type 1: # Disclosed in both expenses account	5	6	22	28	33	570	780	943	959	3,346
Type 1-1: #Disclosed in "Other Cash Payment" account as well	4	4	16	20	23	272	366	398	398	1,501
Type 2: # Disclosed only in one expense or "Other Cash Payment" account	456	468	515	571	595	476	521	578	630	4,810
Type 2-1: # Disclosed only in the account of Management Expense	10	8	8	18	27	307	380	452	484	1,694
Type 2-2: # Disclosed only in the account of Sales Expense	2	1	2	7	8	21	33	45	64	183
Type 2-3: # Disclosed only in "Other Cash Payment" account	444	459	504	546	560	148	108	81	82	2,932
Type 3: # Disclosed in one expenses account and "Other Cash Payment" account	12	13	14	24	24	212	254	272	283	1,108
Type 3-1: # Disclosed in the account of Management Expense	11	11	12	21	18	198	234	246	255	1,006
Type 3-2: # Disclosed in the account of Sales Expense	1	2	2	3	6	14	20	26	28	102

**Table 1. Summary Statistics**

This table presents the summary statistics for the sample firms between 2004 and 2012. Panel A and B provide the summary statistics of BEE by year and industry, respectively. The 21 industries are based on the official industry classification of the China Securities Regulatory Commission. Panel C reports the summary statistics for the main variables used in this paper. All variables are defined in the Appendix A.

Panel A. Summary Statistics of BEE by Year

year	#Firm-year with BEE	%Disclosure rate	% BEE/TA			% BEE/Sales			% BEE/Operating Profit		
			Mean	Median	S.D.	Mean	Median	S.D.	Mean	Median	S.D.
2004	433	36.05	0.23	0.17	0.22	0.46	0.27	0.56	10.06	4.28	20.52
2005	437	36.42	0.24	0.18	0.22	0.46	0.28	0.55	12.54	5.30	23.79
2006	491	39.50	0.24	0.19	0.22	0.43	0.28	0.49	11.05	4.44	20.56
2007	566	43.34	0.25	0.18	0.24	0.45	0.27	0.61	9.12	3.42	22.11
2008	541	43.42	0.26	0.19	0.26	0.49	0.30	0.65	10.66	4.24	22.50
2009	792	76.74	0.25	0.17	0.26	0.51	0.32	0.61	11.14	4.02	22.83
2010	1,404	78.97	0.26	0.18	0.26	0.54	0.33	0.65	8.90	3.64	18.21
2011	1,664	79.96	0.28	0.19	0.26	0.57	0.34	0.69	10.24	4.00	21.07
2012	1,772	77.86	0.28	0.19	0.27	0.59	0.36	0.68	11.08	4.54	21.53
Total	8,100	60.62	0.26	0.19	0.26	0.53	0.32	0.64	10.37	4.10	21.13

Panel B. Summary Statistics of BEE by Industry

Industry	#Firm-year with BEE	%Disclosure rate	% BEE/TA			% BEE/Sales			% BEE/Operating Profit		
			Mean	Median	S.D.	Mean	Median	S.D.	Mean	Median	S.D.
Information Technology	628	66.74	0.52	0.40	0.40	1.11	0.79	1.00	16.59	7.75	25.94
Pharmaceutical Products	555	62.57	0.36	0.29	0.31	0.69	0.47	0.70	11.64	4.37	22.73
Communication & Culture	80	65.04	0.33	0.27	0.23	0.66	0.51	0.54	5.53	3.58	5.38
Machinery	1,640	65.76	0.30	0.23	0.25	0.60	0.41	0.63	12.29	5.11	23.40
Retail & Wholesale	401	57.12	0.24	0.22	0.15	0.27	0.19	0.39	9.35	4.63	16.58
Other Manufacturing	88	58.28	0.37	0.19	0.39	0.62	0.29	0.80	11.27	4.10	21.99
Electronic	406	58.59	0.26	0.19	0.25	0.51	0.32	0.57	10.18	4.14	20.16
Agriculture	212	68.83	0.22	0.18	0.16	0.58	0.39	0.74	13.56	5.82	25.43
Construction	174	59.59	0.20	0.18	0.11	0.30	0.25	0.20	8.59	5.53	10.98
Social Services	179	52.03	0.22	0.17	0.20	0.66	0.48	0.75	7.72	3.50	18.39
Food	338	59.72	0.24	0.17	0.23	0.37	0.27	0.35	9.40	3.10	23.47
Apparel	334	58.19	0.20	0.16	0.17	0.37	0.24	0.45	9.65	3.50	20.82
Gas and Chemistry	988	65.26	0.21	0.15	0.17	0.34	0.22	0.46	8.11	3.61	17.76
Transportation	185	53.94	0.20	0.15	0.23	0.55	0.43	0.50	6.55	3.09	14.60
Conglomerate	230	44.49	0.21	0.15	0.21	0.65	0.40	0.76	13.18	3.98	27.65
Metal	708	57.70	0.19	0.14	0.19	0.34	0.21	0.48	11.06	3.45	24.10
Printing	154	58.56	0.22	0.13	0.23	0.40	0.25	0.41	9.16	4.22	16.77
Mining	209	64.11	0.18	0.13	0.17	0.34	0.20	0.40	4.29	1.34	12.40
Furniture	36	67.92	0.18	0.13	0.15	0.29	0.25	0.17	8.63	4.24	13.06
Real Estate	290	52.82	0.14	0.10	0.15	0.65	0.37	0.77	4.71	2.01	8.83
Utilities	265	53.43	0.11	0.08	0.11	0.33	0.20	0.37	5.53	2.40	13.66

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Panel C. Firm Characteristics

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	Mean	S.D.	25th Percentile	Median	75th Percentile	N
<i>Corporate Outcomes</i>						
Asset Turnover	0.809	0.627	0.420	0.652	0.988	8100
ROA	0.046	0.072	0.014	0.039	0.077	8100
Tobin's Q	2.492	1.477	1.470	2.050	3.010	8100
UE	-0.897	1.752	-1.118	-0.319	0.000	4613
Reserve ratio of AR	0.370	0.265	0.166	0.280	0.514	7554
AP/TA	0.106	0.083	0.046	0.084	0.142	8100
Subsidy/TA	0.731	0.931	0.149	0.391	0.925	6342
Collateral	0.415	0.318	0.138	0.342	0.660	4991
Litigation incidence	0.094	0.292	0.000	0.000	0.000	8100
<i>Other Firm Characteristics</i>						
Customer-Base Concentration	0.307	0.230	0.137	0.241	0.420	13363
Supplier-Base Concentration	0.374	0.225	0.202	0.325	0.507	13363
RPT / TA	0.243	0.347	0.025	0.129	0.320	13363
Litigation risk	0.235	0.424	0.000	0.000	0.000	13363
Reserve of receivables	1.097	1.904	0.155	0.522	1.215	13363
SOE	0.540	0.498	0.000	1.000	1.000	13363
Political connectedness	0.443	0.497	0.000	0.000	1.000	13363
Leverage	0.463	0.212	0.303	0.476	0.623	13363
Firm age	2.441	0.451	2.197	2.485	2.773	13363
PCM	0.094	0.153	0.035	0.085	0.160	13363
Fraction of outside directors	0.612	0.191	0.444	0.600	0.778	13363
Duality	0.190	0.392	0.000	0.000	0.000	13363
Board size	2.303	0.183	2.303	2.303	2.303	13363
Largest shareholder's ownership	0.374	0.157	0.250	0.355	0.492	13363
Managerial ownership	0.075	0.173	0.000	0.000	0.003	13363
Mutual funds' ownership	0.042	0.072	0.000	0.007	0.051	13363
Herfindahl index (2-10)	0.020	0.026	0.002	0.008	0.029	13363
Remuneration	0.067	0.085	0.021	0.044	0.086	13363
lnMKV	21.155	1.217	20.270	21.094	21.907	13363
lnB2M	-0.326	0.915	-0.921	-0.259	0.331	13363
Cash availability	0.200	0.160	0.087	0.152	0.265	13363
Market Development	8.712	2.082	7.230	8.930	10.420	13363
SD_FEPS	0.115	0.117	0.036	0.074	0.150	4613
Ratio of long term loan	0.267	0.306	0.000	0.143	0.461	4991
Z-Score	9.509	3.689	7.165	9.262	11.414	4991
IMR	0.416	0.439	0.088	0.196	0.748	8100

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**Table 2. Determinants of Disclosure Decisions and BEE**

This table reports the determinants of disclosure decisions in Column 1 and the determinants of BEE in Columns 2 and 3. The dependent variable in Column 1 is a dummy variable, set at one if a firm disclosed BEE in a given year. The dependent variable in Columns 2 and 3 is BEE divided by total assets in percentage. The explanatory variables in Column 1 are measured at concurrent year t and in Columns 2 and 3 are calculated at year t-1. All explanatory variables are defined in Appendix A. Both the industry and the year fixed effects are included. In Column 3, the firm fixed effects are further controlled for. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	Disclosure Decision		Determinants of BEE			
	(1)	(2)	(2)	(3)	(3)	(3)
Early listers	-0.121**	(-2.063)				
GME market in Shenzhen SE	0.204	(1.183)				
Shanghai SE	-0.153*	(-1.647)				
Customer-Base Concentration	-0.063	(-0.489)	-0.124***	(-10.259)	-0.028*	(-1.769)
Supplier-Base Concentration	0.119	(0.942)	-0.076***	(-6.268)	-0.017	(-1.147)
Reserve of receivables	-0.010	(-0.598)	0.027***	(15.137)	0.008***	(4.022)
RPT / TA	0.016	(0.200)	-0.017*	(-1.799)	-0.007	(-0.887)
Litigation risk	-0.018	(-0.347)	0.019***	(2.977)	0.015***	(2.838)
SOE	0.136*	(1.779)	0.012*	(1.956)	0.010	(0.951)
Political connectedness	0.010	(0.152)	0.007	(1.412)	0.019***	(2.836)
Leverage	-0.097	(-0.579)	-0.038**	(-2.337)	-0.040**	(-1.974)
Firm age			-0.030***	(-4.677)	0.012	(0.542)
PCM	-0.014	(-0.093)	-0.047**	(-2.353)	0.011	(0.613)
Fraction of Outside directors	-0.241*	(-1.803)	0.009	(0.673)	-0.039***	(-2.785)
Duality	-0.044	(-0.674)	0.004	(0.660)	0.005	(0.789)
Board size	-0.040	(-0.259)	0.040***	(2.778)	-0.006	(-0.346)
Largest shareholder's ownership	-0.151	(-0.681)	-0.110***	(-5.879)	-0.052	(-1.638)
Managerial ownership	0.665**	(2.563)	0.006	(0.319)	0.034	(0.672)
Mutual funds' ownership	0.238	(0.635)	0.127***	(3.115)	-0.030	(-0.884)
Herfindahl index (2-10)	-2.178*	(-1.767)	-0.057	(-0.499)	-0.012	(-0.071)
Remuneration	-0.611**	(-1.969)	0.568***	(14.497)	0.146***	(3.248)
lnMKV	-0.305***	(-7.294)	-0.021***	(-4.713)	-0.044***	(-7.291)
lnB2M	-0.198***	(-4.731)	-0.035***	(-7.581)	-0.037***	(-7.129)
Cash availability	0.494**	(2.466)	0.091***	(4.443)	0.012	(0.554)
Market Development	-0.111***	(-5.202)	0.008***	(5.167)	0.015**	(2.462)
IMR			0.035*	(1.811)	0.036**	(1.993)
Constant	6.827***	(7.377)	0.577***	(6.387)	1.069***	(7.879)
Year and Industry FE	Yes		Yes		Yes	
Firm FE	No		No		Yes	
Observations	13,363		6,649		6,649	
Pesudo R <sup>2</sup> / Adjusted R <sup>2</sup>	0.158		0.263		0.773	

**Table 3. BEE and Future Performance**

This table reports the results of using BEE to predict future accounting performance. In Panel A, the dependent variable is Asset Turnover, defined as sales at year t+1 divided by total assets at year t. The dependent variable in Panel B is ROA, calculated as net income at year t+1 divided by total assets at year t. In Panel C, the dependent variable is Tobin's Q, measured as the ratio of the sum of the market value of equity and the book value of total liabilities at the end of April in year t+1 over total assets at year t. Columns 1 to 3 in each panel present estimates from ordinary least squares, while Column 4 displays the instrumental variable estimates. The instrumental variable is the median BEE of other firms within the same industry at the two-digit level in a given year. All explanatory variables are defined in the Appendix A. Both industry and year fixed effects are included. In Column 3, the firm fixed effects are further controlled for. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	OLS				IV			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
BEE	0.394***	(8.271)	0.147***	(6.231)	0.267***	(5.015)	0.455**	(2.105)
Customer-Base Concentration	-0.189***	(-3.651)	-0.074***	(-3.116)	-0.046	(-0.942)	-0.037	(-0.965)
Supplier-Base Concentration	0.026	(0.435)	-0.025	(-0.998)	-0.018	(-0.437)	-0.005	(-0.177)
Reserve of receivables	-0.022***	(-2.769)	-0.005	(-1.223)	-0.002	(-0.354)	-0.012*	(-1.938)
RPT / TA	0.411***	(8.511)	0.116***	(5.268)	0.089***	(3.011)	0.125***	(5.505)
Litigation risk	0.005	(0.230)	-0.012	(-1.129)	-0.011	(-0.760)	-0.014	(-1.193)
SOE	0.030	(1.051)	0.026**	(2.223)	0.090**	(2.069)	0.023*	(1.811)
Political connectedness	0.005	(0.242)	0.002	(0.233)	-0.026	(-1.126)	-0.002	(-0.199)
Leverage	0.354***	(4.695)	-0.072**	(-2.218)	-0.425***	(-5.774)	-0.049	(-1.334)
Firm age	-0.019	(-0.869)	0.006	(0.609)	0.115**	(2.051)	0.014	(1.212)
PCM	-0.321***	(-4.013)	-0.292***	(-6.242)	-0.034	(-0.569)	-0.273***	(-5.487)
Fraction of Outside directors	0.079	(1.375)	0.020	(0.741)	0.066	(1.473)	0.017	(0.617)
Duality	-0.020	(-0.968)	-0.012	(-1.238)	-0.007	(-0.403)	-0.014	(-1.361)
Board size	0.067	(1.204)	0.035	(1.411)	0.067	(1.042)	0.024	(0.872)
Largest shareholder's ownership	0.289***	(3.829)	0.081**	(2.433)	0.041	(0.349)	0.108***	(2.702)
Managerial ownership	0.011	(0.204)	-0.034	(-1.388)	-0.005	(-0.048)	-0.035	(-1.340)
Mutual funds' ownership	0.937***	(6.150)	0.325***	(4.487)	0.520***	(5.112)	0.293***	(3.631)
Herfindahl index (2-10)	1.029**	(2.057)	0.011	(0.049)	-0.075	(-0.118)	0.080	(0.331)
Remuneration	0.547***	(3.105)	0.227**	(2.535)	0.555***	(2.989)	0.068	(0.475)
lnMKV	0.051***	(2.776)	0.013	(1.516)	-0.180***	(-7.523)	0.022**	(2.025)
lnB2M	0.017	(0.932)	-0.057***	(-5.705)	-0.208***	(-9.345)	-0.043***	(-3.108)
Cash availability	0.108	(1.396)	-0.382***	(-9.406)	-0.339***	(-5.679)	-0.378***	(-9.025)
Market Development	0.030***	(5.078)	0.010***	(4.039)	-0.049**	(-2.556)	0.009***	(3.086)
IMR	-0.115	(-1.426)	-0.067*	(-1.775)	0.166***	(2.592)	-0.085**	(-2.064)
Asset Turnover (t)			0.707***	(41.126)	0.213***	(10.180)	0.691***	(33.150)
Constant	-1.098***	(-3.142)	-0.189	(-1.178)	3.723***	(6.241)	-0.542**	(-2.048)
Year and Industry FE	Yes		Yes		Yes		Yes	
Firm FE	No		No		Yes		No	
Observations	8,100		8,100		8,100		8,100	
Adjusted R <sup>2</sup>	0.270		0.665		0.791		0.655	

**Table 3 - Continued**

Panel B. ROA								
	OLS						IV	
	(1)		(2)		(3)		(4)	
BEE	0.027***	(6.584)	0.020***	(5.901)	0.025***	(3.291)	0.115***	(3.028)
Customer-Base Concentration	-0.006	(-1.521)	-0.006*	(-1.733)	0.006	(0.777)	0.007	(1.077)
Supplier-Base Concentration	-0.001	(-0.252)	-0.002	(-0.637)	-0.003	(-0.401)	0.004	(0.875)
Reserve of receivables	-0.003***	(-3.797)	-0.002***	(-2.857)	-0.002	(-1.369)	-0.004***	(-3.479)
RPT / TA	-0.002	(-0.443)	-0.003	(-1.141)	0.001	(0.306)	-0.002	(-0.721)
Litigation risk	-0.001	(-0.553)	-0.003	(-1.583)	0.001	(0.317)	-0.003	(-1.605)
SOE	-0.006***	(-2.987)	-0.003*	(-1.948)	-0.015*	(-1.868)	-0.005**	(-2.259)
Political connectedness	0.002	(1.374)	0.002	(1.545)	0.000	(0.069)	0.001	(0.561)
Leverage	-0.059***	(-10.344)	-0.041***	(-8.502)	-0.039***	(-3.549)	-0.039***	(-6.869)
Firm age	0.004*	(1.859)	0.003**	(2.104)	-0.008	(-0.792)	0.006***	(2.748)
PCM	0.117***	(12.784)	0.043***	(5.092)	0.021	(1.560)	0.055***	(5.295)
Fraction of Outside directors	0.002	(0.426)	0.001	(0.132)	0.002	(0.199)	-0.001	(-0.145)
Duality	-0.005***	(-2.718)	-0.005***	(-3.159)	-0.002	(-0.669)	-0.006***	(-2.951)
Board size	-0.004	(-0.870)	-0.002	(-0.701)	-0.004	(-0.498)	-0.006	(-1.479)
Largest shareholder's ownership	0.058***	(9.636)	0.042***	(8.607)	0.092***	(5.149)	0.051***	(7.581)
Managerial ownership	0.010*	(1.946)	0.004	(1.050)	-0.003	(-0.143)	0.004	(0.836)
Mutual funds' ownership	0.184***	(13.362)	0.135***	(11.504)	0.123***	(8.136)	0.125***	(9.141)
Herfindahl index (2-10)	0.178***	(5.189)	0.108***	(3.805)	0.213**	(2.537)	0.128***	(3.625)
Remuneration	0.080***	(5.245)	0.062***	(4.104)	0.112***	(4.779)	0.012	(0.465)
lnMKV	0.011***	(6.993)	0.008***	(5.613)	-0.025***	(-6.446)	0.011***	(5.482)
lnB2M	-0.008***	(-4.781)	-0.009***	(-5.694)	-0.033***	(-7.719)	-0.005**	(-2.110)
Cash availability	0.034***	(5.272)	0.003	(0.499)	0.021**	(2.241)	0.003	(0.489)
Market Development	0.002***	(3.467)	0.001***	(3.507)	-0.000	(-0.108)	0.001	(1.570)
IMR	-0.018**	(-2.526)	-0.016**	(-2.523)	0.006	(0.624)	-0.021***	(-2.941)
ROA(t)			0.323***	(19.890)	0.123***	(6.544)	0.296***	(14.529)
Constant	-0.217***	(-7.302)	-0.154***	(-5.993)	0.499***	(5.696)	-0.257***	(-5.436)
Year and Industry FE	Yes		Yes		Yes		Yes	
Firm FE	No		No		Yes		No	
Observations	8,100		8,100		8,100		8,100	
Adjusted R <sup>2</sup>	0.364		0.420		0.528		0.348	



**Table 3 - Continued**

	Panel C. Tobin's Q							
	OLS				IV			
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
BEE	0.492***	(4.466)	0.194***	(3.143)	0.862***	(6.161)	9.351***	(7.086)
Customer-Base Concentration	0.720***	(6.971)	0.310***	(5.518)	0.577***	(4.263)	1.450***	(6.241)
Supplier-Base Concentration	0.271***	(2.817)	0.065	(1.192)	-0.062	(-0.511)	0.603***	(3.147)
Reserve of receivables	0.106***	(5.354)	0.068***	(6.433)	0.061***	(3.260)	-0.161***	(-3.650)
RPT / TA	0.033	(0.491)	0.022	(0.531)	0.154**	(2.142)	0.108	(0.922)
Litigation risk	0.321***	(6.791)	0.076***	(3.151)	0.066*	(1.745)	0.037	(0.438)
SOE	-0.359***	(-6.816)	-0.112***	(-3.953)	-0.349***	(-3.146)	-0.226**	(-2.136)
Political connectedness	-0.076**	(-1.993)	-0.049**	(-2.413)	-0.089	(-1.571)	-0.145*	(-1.871)
Leverage	-1.173***	(-8.810)	-0.439***	(-5.406)	-0.327*	(-1.701)	-0.533**	(-2.383)
Firm age	-0.030	(-0.586)	0.025	(0.838)	-0.706***	(-3.256)	0.327***	(2.694)
PCM	0.521***	(2.660)	-0.078	(-0.670)	0.224	(1.187)	0.547**	(2.062)
Fraction of Outside directors	0.445***	(4.362)	0.157***	(2.605)	0.308**	(2.469)	-0.030	(-0.141)
Duality	0.064	(1.424)	0.025	(0.909)	-0.077	(-1.235)	-0.037	(-0.365)
Board size	-0.409***	(-3.890)	-0.164***	(-2.883)	-0.015	(-0.103)	-0.449**	(-2.006)
Largest shareholder's ownership	0.613***	(4.197)	0.245***	(3.121)	-0.117	(-0.418)	1.526***	(4.523)
Managerial ownership	-0.052	(-0.370)	0.004	(0.053)	0.709	(1.466)	0.200	(0.603)
Mutual funds' ownership	1.889***	(5.619)	1.028***	(5.338)	1.822***	(5.865)	-0.392	(-0.621)
Herfindahl index (2-10)	3.143***	(4.142)	0.670	(1.518)	-1.766	(-1.117)	3.358*	(1.913)
Remuneration	5.788***	(13.962)	2.945***	(10.270)	5.263***	(9.563)	-2.525**	(-2.366)
lnMKV	0.518***	(14.380)	0.227***	(9.992)	0.388***	(9.256)	0.374***	(5.801)
Cash availability	-0.134	(-0.830)	-0.382***	(-3.831)	-0.566***	(-2.817)	-0.565*	(-1.772)
Market Development	0.013	(1.011)	0.018***	(2.631)	-0.049	(-0.874)	-0.057**	(-2.292)
IMR	-2.365***	(-15.082)	-1.185***	(-11.884)	-0.820***	(-4.792)	-1.346***	(-4.775)
Tobin' Q (t-1)			0.610***	(35.508)	0.221***	(10.938)	0.471***	(11.332)
Constant	-5.978***	(-8.428)	-3.059***	(-7.519)	-4.119***	(-3.813)	-8.943***	(-5.680)
Year and Industry FE	Yes		Yes		Yes		Yes	
Firm FE	No		No		Yes		No	
Observations	8,100		7,158		7,158		7,158	
Adjusted R <sup>2</sup>	0.471		0.691		0.750		0.575	

**Table 4. BEE and Future Stock Returns**

This table reports the results of using BEE to predict future stock returns. In Panels A and B, all stocks are equal-weighted and value-weighted by tradable market capitalization, respectively. Reported numbers are alphas derived from the CAPM, Fama-French (1993) three factor, and Carhart (1997) four-factor model for each quintile portfolio formed on BEE. For each two-digit industry in each year between 2004 and 2012, we sort firms into five quintiles based on BEE, and hold the portfolio for 12 months from May 1 (year+1) to April 30 (year t+2). Portfolio 1 contains stocks in the lowest 20 percentiles, and Portfolio 5 contains stocks in the highest 20 percentiles. “5 - 1” holds Portfolio 5 long and Portfolio 1 short. Four risk factors (MKT, SMB, HML and UMD) are constructed from all Chinese stocks using the Fama-French (1993) methodology. In total, there are 108 months. The t-statistics computed are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

1 (Lowest)	2	3	4	5 (Highest)	5 - 1
Panel A. Equal-Weighted (%)					
CAPM					
0.958*	1.144**	1.096**	1.218**	1.470***	0.512***
(1.836)	(2.244)	(2.115)	(2.408)	(2.787)	(3.380)
Fama-French Three-factor					
-0.160	0.021	-0.080	0.092	0.265	0.425***
(-0.465)	(0.064)	(-0.261)	(0.306)	(0.870)	(2.760)
Carhart Four-Factor					
-0.197	-0.009	-0.113	0.060	0.239	0.437***
(-0.605)	(-0.029)	(-0.386)	(0.208)	(0.806)	(2.890)
Panel B. Value-Weighted (% by Tradable Market Capitalization)					
CAPM					
0.305	0.515	0.679	0.694	1.364***	1.059***
(0.769)	(1.229)	(1.547)	(1.640)	(2.844)	(3.690)
Fama-French Three-factor					
-0.300	-0.212	-0.185	-0.046	0.411	0.711***
(-0.892)	(-0.628)	(-0.605)	(-0.146)	(1.325)	(2.750)
Carhart Four-Factor					
-0.329	-0.241	-0.215	-0.074	0.400	0.728***
(-1.004)	(-0.733)	(-0.731)	(-0.241)	(1.289)	(2.850)

**Table 5. BEE and Unexpected Future Earnings**

This table reports the results of using BEE to predict unexpected future earnings. The dependent variable is unexpected future earnings, measured as the analyst forecast error scaled by the stock price two days prior to the earnings announcement. Forecast error is defined as actual earnings per share minus the median earnings forecast from -12 months to 2 days prior to the earnings announcement. Column 1 presents the estimates from ordinary least squares, while Column 2 displays instrumental variable estimates. All explanatory variables are defined in Appendix A. Both industry and year fixed effects are included. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	OLS		IV	
	(1)	(2)	(1)	(2)
BEE	0.409***	(4.056)	2.125**	(1.967)
SD_FEPS	-4.720***	(-15.338)	-4.706***	(-15.191)
Customer-Base Concentration	0.137	(1.129)	0.387*	(1.925)
Supplier-Base Concentration	-0.164	(-1.412)	-0.051	(-0.351)
Reserve of receivables	-0.046**	(-1.982)	-0.110**	(-2.287)
RPT / TA	-0.002	(-0.016)	0.034	(0.297)
Litigation risk	-0.108	(-1.563)	-0.100	(-1.402)
SOE	0.020	(0.315)	-0.016	(-0.229)
Political connectedness	0.056	(1.194)	0.031	(0.613)
Leverage	-0.536***	(-2.852)	-0.432**	(-2.065)
Firm age	0.057	(1.148)	0.100	(1.627)
PCM	0.334	(1.392)	0.650**	(2.077)
Fraction of Outside directors	0.050	(0.334)	-0.005	(-0.030)
Duality	-0.002	(-0.032)	-0.012	(-0.217)
Board size	0.207	(1.390)	0.125	(0.774)
Largest shareholder's ownership	0.725***	(4.090)	0.755***	(4.066)
Managerial ownership	0.177	(1.296)	0.118	(0.790)
Mutual funds' ownership	1.321***	(3.866)	1.025**	(2.539)
Herfindahl index (2-10)	1.569	(1.498)	2.097*	(1.803)
Remuneration	-0.332	(-1.201)	-1.414*	(-1.888)
lnMKV	-0.030	(-0.659)	0.035	(0.553)
lnB2M	-0.114**	(-2.311)	-0.026	(-0.353)
Cash availability	0.797***	(4.517)	0.820***	(4.343)
Market Development	0.021	(1.467)	0.010	(0.632)
IMR	-0.343*	(-1.679)	-0.464**	(-2.041)
Constant	-1.318	(-1.498)	-2.768**	(-2.136)
Year and Industry FE		Yes		Yes
Observations		4,613		4,613
Adjusted R <sup>2</sup>		0.189		0.143

**Table 6. BEE and Trade Credits with Customers and Suppliers**

This table reports the effect of BEE on the quality of trade credit extended to customers and acquiring trade credit from suppliers. The dependent variables in Columns 1 and 2 are the reserve ratio of AR, defined as total reserves for long-term account receivables divided by total long-term account receivables at year t+1. The dependent variables in Columns 3 and 4 are the account payables at year t+1 scaled by total assets at year t. Columns 1 and 3 present estimates from ordinary least squares, while Columns 2 and 4 display instrumental variable estimates. The instrumental variable is the median BEE of other firms within the same industry at the two-digit level in a given year. All explanatory variables are defined in the Appendix A. Both industry and year fixed effects are included. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	Reserve Ratio of AR				Trade Credit from Suppliers			
	OLS		IV		OLS		IV	
	(1)	(2)	(3)	(4)	(3)	(4)	(3)	(4)
BEE	-0.077***	(-3.968)	-0.837***	(-2.654)	0.055***	(8.046)	0.278***	(3.026)
Customer-Base Concentration	-0.017	(-0.726)	-0.121**	(-2.479)	0.041***	(6.337)	0.071***	(4.791)
Supplier-Base Concentration	0.088***	(3.905)	0.026	(0.739)	-0.068***	(-10.909)	-0.051***	(-5.098)
Reserve of receivables	0.049***	(14.563)	0.070***	(7.173)	0.006***	(4.910)	-0.001	(-0.323)
RPT / TA	0.020	(1.098)	0.011	(0.551)	0.013**	(2.444)	0.016**	(2.553)
Litigation risk	0.008	(0.717)	0.012	(0.934)	-0.001	(-0.471)	-0.003	(-0.722)
SOE	0.065***	(5.080)	0.071***	(4.632)	0.008**	(2.365)	0.005	(1.293)
Political connectedness	-0.016*	(-1.743)	-0.006	(-0.533)	-0.003	(-1.196)	-0.006*	(-1.800)
Leverage	-0.072**	(-2.200)	-0.098**	(-2.393)	0.121***	(13.784)	0.131***	(12.433)
Firm age	0.033***	(3.142)	0.015	(0.991)	-0.012***	(-3.543)	-0.005	(-1.053)
PCM	-0.084**	(-2.170)	-0.145***	(-2.843)	-0.034***	(-3.507)	-0.021	(-1.584)
Fraction of Outside directors	-0.052**	(-1.981)	-0.032	(-0.998)	0.034***	(4.886)	0.029***	(3.336)
Duality	-0.030***	(-3.124)	-0.024*	(-1.838)	0.001	(0.217)	-0.001	(-0.220)
Board size	0.010	(0.336)	0.046	(1.284)	0.010	(1.364)	0.002	(0.218)
Largest shareholder's ownership	0.053	(1.479)	0.005	(0.111)	0.025**	(2.383)	0.041***	(2.954)
Managerial ownership	-0.020	(-0.788)	-0.016	(-0.461)	0.001	(0.143)	-0.000	(-0.017)
Mutual funds' ownership	-0.189**	(-2.413)	-0.051	(-0.483)	0.145***	(6.090)	0.102***	(2.991)
Herfindahl index (2-10)	-0.146	(-0.700)	-0.236	(-0.984)	0.103*	(1.732)	0.128*	(1.816)
Remuneration	0.067	(0.927)	0.660**	(2.434)	0.045**	(2.004)	-0.095	(-1.523)
lnMKV	0.004	(0.481)	-0.010	(-0.808)	0.009***	(3.425)	0.014***	(3.828)
lnB2M	-0.027***	(-3.113)	-0.056***	(-3.646)	0.010***	(3.966)	0.019***	(4.000)
Cash availability	-0.016	(-0.481)	0.016	(0.386)	0.000	(0.000)	-0.009	(-0.751)
Market Development	0.000	(0.045)	0.006	(1.449)	0.004***	(5.654)	0.002**	(2.087)
IMR	0.184***	(4.894)	0.216***	(4.348)	-0.058***	(-5.531)	-0.067***	(-5.058)
Constant	-0.099	(-0.533)	0.471	(1.585)	-0.194***	(-3.943)	-0.387***	(-4.231)
Year and Industry FE	Yes		Yes		Yes		Yes	
Observations	7,554		7,554		8,100		8,100	
Adjusted R <sup>2</sup>	0.187		0.189		0.302		0.294	

**Table 7. Transaction Costs, BEE and Trade Credit with Customers and Suppliers**

This table reports the subsample test for the effects of BEE on trade credit with customers and suppliers. In Panel A, the dependent variables are reserve ratio of AR, defined as total reserves of account receivables divided by total account receivables at year t+1. The sorting variables for Columns 1 - 4 are customer-base concentration and whether the firm is in high-tech industry. In Panel B, the dependent variables are account payables defined as account payables at year t+1 divided by total assets at year t. The sorting variables for Columns (1) - (4) are supplier-base concentration and whether the firm is in high-tech industry. For continuous sorting variables, we sort the firms into terciles and keep only the top and bottom terciles. For brevity, estimates for all other control variables and the constant term are omitted. Both industry and year fixed effects are included. "Wald test: Equality of Coef." reports the P-value of the Wald test of equality of the BEE coefficients between subsamples. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

Panel A. Reserve Ratio for AR				
	Customer-Base Concentration		High- vs Low-Tech Industry	
	High	Low	High-Tech	Low-Tech
	(1)	(2)	(3)	(4)
BEE	-0.060**	-0.063***	-0.093***	0.045
	(-2.382)	(-2.698)	(-5.486)	(1.084)
Other Controls	Yes	Yes	Yes	Yes
Year and Industry FE	Yes	Yes	Yes	Yes
Wald test: Equality of Coef.	0.915		0.000***	
Observations	2,511	2,511	2,303	1,537
Adjusted R <sup>2</sup>	0.181	0.201	0.223	0.186
Panel B. Trade Credit from Suppliers				
	Supplier-Base Concentration		High- vs Low-Tech Industry	
	High	Low	High-Tech	Low-Tech
	(1)	(2)	(3)	(4)
BEE	0.035***	0.068***	0.042***	0.023**
	(5.730)	(9.799)	(7.157)	(2.392)
Other Controls	Yes	Yes	Yes	Yes
Year and Industry FE	Yes	Yes	Yes	Yes
Wald test: Equality of Coef.	0.027**		0.030**	
Observations	2,703	2,704	2,416	1,698
Adjusted R <sup>2</sup>	0.191	0.353	0.324	0.452

**Table 8. BEE and Future Litigation Incidence**

This table reports the effect of BEE on future litigation incidence. The dependent variable is a dummy variable, which is coded as one if a firm has any lawsuits at year t+1. Columns 1, 3 and (4) present estimates from probit models, while Column 2 displays instrumental variable estimates. The instrumental variable is the median BEE of other firms within the same industry at the two-digit level in a given year. Columns (3) and (4) report subsample estimates, with the sorting variable as the ratio of related party transactions to total assets at year t. We sort the firms into terciles and keep only the top and bottom terciles. All explanatory variables are defined in Appendix A. Both industry and year fixed effects are included. In Column (2), firm fixed effects are further controlled. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	Probit		IV Probit		OLS - High RPT		OLS - Low RPT	
	(1)	(2)	(3)	(4)	(3)	(4)	(3)	(4)
BEE	-0.190***	(-3.085)	-1.434***	(-2.613)	-0.016	(-0.497)	-0.052**	(-2.175)
Customer-Base Concentration	-0.043	(-0.214)	-0.202	(-1.050)	-0.021	(-0.743)	0.010	(0.395)
Supplier-Base Concentration	-0.180	(-1.641)	-0.269***	(-2.864)	-0.025	(-0.886)	-0.018	(-0.686)
Reserve of receivables	-0.050	(-0.513)	-0.061	(-0.582)	0.000	(0.023)	-0.575	(-1.639)
RPT / TA	0.475***	(11.348)	0.469***	(10.505)	0.088***	(6.265)	0.063***	(4.229)
Litigation risk	0.034***	(3.453)	0.067***	(3.153)	0.006	(1.465)	0.020***	(4.645)
SOE	-0.585***	(-4.185)	-0.637***	(-3.556)	-0.173***	(-3.394)	-0.069*	(-1.800)
Political connectedness	-0.079*	(-1.881)	-0.062	(-1.540)	-0.026*	(-1.779)	-0.017	(-1.216)
Leverage	-0.070	(-0.827)	-0.053	(-0.709)	-0.004	(-0.306)	-0.017	(-1.623)
Firm age	0.744***	(5.089)	0.661***	(5.176)	0.140***	(3.504)	0.128***	(3.623)
PCM	0.004	(0.053)	-0.031	(-0.414)	0.001	(0.067)	0.002	(0.195)
Fraction of Outside directors	0.098	(0.612)	0.120	(0.765)	0.041	(1.237)	-0.001	(-0.028)
Duality	-0.015	(-0.165)	-0.007	(-0.068)	-0.010	(-0.597)	0.005	(0.452)
Board size	0.034	(0.393)	0.079	(0.895)	0.069**	(2.062)	-0.045	(-1.442)
Largest shareholder's ownership	-0.401***	(-4.175)	-0.478***	(-4.254)	-0.036	(-0.793)	-0.039	(-0.988)
Managerial ownership	0.057	(0.715)	0.063	(0.680)	0.020	(0.350)	-0.007	(-0.217)
Mutual funds' ownership	-0.729	(-1.223)	-0.483	(-0.675)	-0.022	(-0.218)	-0.074	(-0.795)
Herfindahl index (2-10)	1.800***	(3.183)	1.610**	(2.307)	0.488	(1.626)	0.383*	(1.661)
Remuneration	0.312	(0.800)	1.018**	(2.416)	0.286**	(2.045)	0.060	(0.960)
lnMKV	-0.018	(-0.952)	-0.046**	(-2.011)	-0.002	(-0.189)	-0.007	(-0.685)
lnB2M	-0.066**	(-2.088)	-0.114***	(-2.795)	-0.008	(-0.746)	-0.013	(-1.228)
Cash availability	-0.337*	(-1.876)	-0.280	(-1.498)	-0.071	(-1.198)	-0.016	(-0.409)
Market Development	0.001	(0.056)	0.011	(0.764)	-0.000	(-0.072)	-0.004	(-1.206)
IMR	0.094	(0.615)	0.134	(1.089)	-0.029	(-0.554)	0.045	(1.056)
Constant	-0.866*	(-1.939)	-0.076	(-0.147)	-0.000	(-0.001)	0.370*	(1.888)
Year and Industry FE	Yes		Yes		Yes		Yes	
Observations	8,100		8,100		2,703		2,703	
Adjusted R <sup>2</sup>	0.117				0.064		0.081	

**Table 9. BEE and Benefits from Non-market-based Transactions**

This table reports the effect of BEE on government subsidy and collateral requirement on banking borrowings. The dependent variables in Columns 1 and 2 are the amount of government subsidy received at year t+1 scaled by total assets at year t in percentage. The dependent variables in Columns 3 and 4 are the ratio of collateralized bank borrowings divided by total bank borrowings at year t+1. Columns 1 and 3 present estimates from ordinary least squares, while Columns 2 and 4 display instrumental variable estimates. The instrumental variable is the median BEE of other firms within the same industry at two-digit level in a given year. All explanatory variables are defined in Appendix A. Both industry and year fixed effects are included. Province fixed effects are further controlled in Columns 1 and 2. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	Government Subsidy				Collateral Requirement on Bank Borrowings			
	OLS		IV		OLS		IV	
	(1)	(2)	(3)	(4)	(3)	(4)	(3)	(4)
BEE	0.517***	(9.269)	1.667***	(2.855)	-0.055**	(-2.498)	-0.477**	(-1.989)
Customer-Base Concentration	-0.187***	(-3.211)	0.012	(0.129)	0.012	(0.561)	-0.039	(-0.827)
Supplier-Base Concentration	-0.049	(-0.832)	0.015	(0.185)	0.049**	(2.401)	0.017	(0.414)
Reserve of receivables	-0.021**	(-2.284)	-0.049**	(-2.425)	0.005	(1.605)	0.014*	(1.850)
RPT / TA	-0.099**	(-2.080)	-0.093*	(-1.879)	-0.054***	(-3.303)	-0.071***	(-2.726)
Litigation risk	0.010	(0.354)	0.004	(0.122)	0.037***	(3.895)	0.041***	(3.564)
SOE	0.032	(1.064)	0.016	(0.508)	-0.094***	(-9.400)	-0.094***	(-6.631)
Political connectedness	0.008	(0.349)	-0.015	(-0.592)	0.004	(0.538)	0.008	(0.626)
Leverage	-0.194**	(-2.502)	-0.130	(-1.594)	-0.233***	(-8.214)	-0.243***	(-4.247)
Firm age	-0.066**	(-2.316)	-0.058*	(-1.870)	0.059***	(5.241)	0.042***	(2.629)
PCM	-0.660***	(-6.285)	-0.563***	(-4.765)	-0.095***	(-2.788)	-0.112**	(-1.998)
Fraction of Outside directors	0.150**	(2.229)	0.149**	(2.076)	-0.139***	(-6.013)	-0.131***	(-3.873)
Duality	0.039	(1.425)	0.043	(1.527)	0.009	(0.863)	0.009	(0.713)
Board size	0.079	(1.151)	0.025	(0.340)	-0.029	(-1.235)	-0.014	(-0.227)
Largest shareholder's ownership	0.174**	(2.031)	0.228**	(2.417)	-0.042	(-1.387)	-0.071	(-1.419)
Managerial ownership	0.216***	(2.809)	0.175**	(2.209)	0.048	(1.548)	0.042	(1.179)
Mutual funds' ownership	0.904***	(4.974)	0.667***	(3.087)	-0.211***	(-3.157)	-0.180**	(-2.117)
Herfindahl index (2-10)	1.195**	(2.267)	1.454***	(2.597)	-0.394**	(-2.061)	-0.534*	(-1.763)
Remuneration	0.571***	(3.232)	-0.157	(-0.388)	0.105	(1.342)	0.385*	(1.724)
lnMKV	-0.041*	(-1.781)	-0.013	(-0.507)	-0.076***	(-9.467)	-0.090***	(-6.887)
lnB2M	-0.162***	(-7.412)	-0.111***	(-3.655)	-0.067***	(-8.494)	-0.087***	(-4.806)
Cash availability	0.079	(0.836)	0.081	(0.826)	0.191***	(4.909)	0.183**	(2.492)
Market Development	-0.038	(-0.532)	-0.034	(-0.461)	-0.004	(-1.421)	-0.003	(-0.664)
Fraction of long term loans					0.202***	(13.003)	0.183***	(5.102)
Z-Score					-0.006***	(-4.551)	-0.002	(-0.519)
IMR	-0.035	(-0.265)	-0.066	(-0.555)	0.002	(0.054)	0.036	(0.659)
Constant	1.921***	(2.700)	1.342	(1.613)	2.215***	(14.426)	2.576***	(8.671)
Year and Industry FE	Yes		Yes		Yes		Yes	
Province FE	Yes		Yes		No		No	
Observations	6,342		6,342		4,991		4,991	
Adjusted R <sup>2</sup>	0.147		0.083		0.268		0.214	

**Table 10. Favoritism, BEE and Benefits from Non-market-based Transactions**

This table reports the subsample test for the effects of BEE on benefits from non-market-based transactions. In Panel A, the dependent variable is government subsidy, defined as government subsidy received at year t+1 divided by total assets at year t in percentage. The sorting variables for Columns 1 - 6 are whether a firm is a SOE, whether a firm has political connectedness, and firm size. In Columns 7 and 8, the sorting variable is based on the tenure of a new government administration at prefecture level. “Early” (“Late”) period refers to the period that both mayors and party heads at prefecture level are in the first two years (the third to fifth year) of their tenure. In Panel B, the dependent variable is the ratio of collateralized bank borrowings divided by total bank borrowings at year t+1. The sorting variables for Columns 1 - 4 are whether a firm is a SOE and whether a firm has political connectedness. In the last four columns, the sorting variables are variables to indicate whether a firm is financial constrained. In Column 5 and 6, the sorting variable is Z-score based on the formula in Altman (2005). In Columns 7 and 8, the sorting variable is dividend payout policy. For continuous sorting variables, we sort the firms into terciles and only keep the top and bottom tercile. For brevity, estimates for all other control variables and constant term are omitted. Both industry and year fixed effects are included. In Panel B, provincial fixed effects are further controlled. “Wald test: Equality of Coef.” reports the P-value of the Wald test of equality of the BEE coefficients between subsamples. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

Panel A. Subsidy from Governments								
	SOEs		Political Connectedness		Firm Size		Prefecture Admin	
	Yes	No	Yes	No	Big	Small	Early	Late
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
BEE	0.638***	0.434***	0.586***	0.456***	0.758***	0.313***	0.620***	0.312**
	(7.071)	(6.039)	(7.138)	(5.927)	(7.746)	(3.250)	(4.646)	(2.212)
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year, Industry and Province FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Wald test: Equality of Coef.	0.013**		0.288		0.009***		0.000***	
Observations	2,946	3,396	2,776	3,566	2,112	2,112	1,216	1,079
Adjusted R <sup>2</sup>	0.159	0.166	0.179	0.149	0.267	0.104	0.141	0.134
Panel B. Collateral Requirement on Bank Borrowings								
	SOEs		Political Connectedness		Z-Score		Dividend Payout	
	Yes	No	Yes	No	High	Low	Yes	No
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
BEE	-0.150***	-0.003	-0.081**	-0.035	0.010	-0.140***	-0.024	-0.112***
	(-2.779)	(-0.094)	(-2.479)	(-1.172)	(0.311)	(-3.017)	(-0.859)	(-3.113)
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year and Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Wald test: Equality of Coef.	0.000***		0.115		0.018**		0.057*	
Observations	2,517	2,474	2,254	2,737	1,664	1,664	3,122	1,869
Adjusted R <sup>2</sup>	0.251	0.232	0.280	0.283	0.231	0.361	0.241	0.327



**Table 11. Corporate Governance, BEE and Benefits from Different Stakeholders**

This table reports the subsample test for the effect of BEE on benefits from different stakeholders based on corporate governance. In each year, we sort all firms into terciles by the fraction of outside directors. “Strong” and “Weak” include firms in the highest and lowest tercile. In Panel A, the dependent variables for the 1 - 2, 3 - 4, and 5 - 6 are Asset Turnover, ROA and Tobin’s Q, which are defined as sales at year t+1 divided by total assets at year t, net income at year t+1 divided by total assets at year t, and the ratio of the sum of market value of equity and book value of total liabilities at the end of April in year t+1 over total assets at year t. Panel B presents the alphas derived from Carhart four-factor model for each quintile portfolio formed on BEE with all stocks are equal-weighted in the left two columns and value-weighted in the right two columns, respectively. Four risk factors (MKT, SMB, HML and UMD) are constructed from all Chinese stocks using the Fama-French (1993) methodology. For each two-digit industry in each year between 2004 and 2012, we sort firms into five quintiles based on BEE, and hold the portfolio for 12 months from May 1 (year+1) to April 30 (year t+2). Portfolio 1 contains stocks in the lowest 20 percentiles, and Portfolio 5 contains stocks in the highest 20 percentiles. “5 - 1” holds Portfolio 5 long and Portfolio 1 short. In total, there are 108 months. For each quintile portfolio in each year, we further sort all firms into terciles by the fraction of outside directors. In Panel C, the dependent variable for column 1 and 2 are unexpected future earnings, measured as the analyst forecast error scaled by the stock price two days prior to the earnings announcement. Forecast error is defined as actual earnings per share minus the median earnings forecast from -12 months to 2 days prior to the earnings announcement. For column 3 and 4, the dependent variables are reserve ratio of AR, defined as total reserves of long-term account receivables divided by total long-term account receivables at year t+1. The dependent variable for Column 5 and 6 are account payables defined as account payables at year t+1 divided by total assets at year t. In Panel D, the dependent variables are the amount of government subsidy received at year t+1 divided by total assets at year t in percentage, the ratio of collateralized bank borrowings divided by total bank borrowings at year t+1, and a dummy variable equal to one if a firm has any lawsuits at year t+1, respectively. For brevity, estimates for all other control variables and constant term are omitted. Both industry and year fixed effects are included. “Wald test: Equality of Coef.” reports the P-value of the Wald test of equality of the BEE coefficients between firms with strong and weak governance. The t-statistics computed with robust standard errors clustered at the firm level are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

**Table 11 - continued**

	Strong	Weak	Strong	Weak	Strong	Weak
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Panel A. Firm Performance</b>						
	Asset Turnover		ROA		Tobin's Q	
BEE	0.542***	0.353***	0.043***	0.016***	0.577***	0.534***
	(10.006)	(7.590)	(7.223)	(2.866)	(5.269)	(4.850)
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year, Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Wald test: Equality of Coef.	0.017**		0.000***		0.773	
Observations	2,702	2,702	2,702	2,702	2,702	2,702
Adjusted R <sup>2</sup>	0.282	0.245	0.305	0.384	0.476	0.502
<b>Panel B. Future Stock Returns</b>						
	Equal Weighted			Value Weighted		
1 (Lowest Portfolio)	-0.429	-0.009			-0.601	-0.226
2	-0.134	0.134			-0.263	-0.305
3	-0.288	-0.094			-0.498	-0.162
4	-0.003	0.110			-0.309	0.247
5(Highest Portfolio)	0.371	0.222			0.305	0.418
5 - 1	0.801***	0.231			0.906**	0.645*
	(3.610)	(0.900)			(2.440)	(1.700)
<b>Panel C. Government Subsidy, Quality of AR, and Utilization of Trade Credit from Suppliers</b>						
	Unexpected Earnings		Reserve Ratio for AR		Account Payables	
BEE	0.759***	0.030	-0.085***	-0.040*	0.071***	0.030***
	3.704	0.146	(-3.456)	(-1.760)	(9.958)	(4.771)
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year, Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Wald test: Equality of Coef.	0.008***		0.039**		0.000***	
Observations	1,479	1,475	2,522	2,522	2,710	2,704
Adjusted R <sup>2</sup>	0.183	0.199	0.189	0.198	0.302	0.292
<b>Panel D. Government Subsidy, Bank Borrowings and Litigation Incidence</b>						
	Subsidy		Collateral		Litigation	
BEE	0.673***	0.327***	-0.121***	-0.028	-0.018	-0.015
	(6.704)	(3.263)	(-3.170)	(-0.701)	(-0.602)	(-0.548)
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year and Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Province FE	Yes	Yes	No	No	No	No
Wald test: Equality of Coef.	0.001***		0.118		0.946	
Observations	2,138	2,141	1,692	1,700	2,710	2,713
Adjusted R <sup>2</sup>	0.185	0.156	0.263	0.285	0.062	0.092